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"COMPARATIVE ANALYSIS OF THE TAX TREATMENT OF BUSINESS INCOME IN FRANCE, THE UNITED STATES, CANADA, AND THE PHILIPPINES"

BY

JOSE ENRIQUEZ SABATER

©

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies for acceptance, a thesis entitled "Comparative Analysis of the Tax Treatment of Business Income in France, the United States, Canada, and the Philippines" submitted by Jose Enriquez Sabater in partial fulfilment of the requirements for the degree of Master of Laws

ABSTRACT

The thesis analyses comparatively the tax treatment of business income in France, the United States, Canada, and the Philippines.

The work is divided into six parts, as follows: I. Introduction; II. Business Income: Tax Consequences and Meaning; III. Deductions; IV. Depreciation and Amortizations; V. Net Loss from Operations; and, VI. Analysis and Conclusion.

The Introduction discusses the importance of the thesis. It also explains why France, the United States, Canada, and the Philippines were selected as the prime specimens of the comparative analysis. In this regard, both economic and legal reasons were cited.

In connection with Business Income: Tax Consequences and Meaning, the discussion covered the following: 1) the various classes of taxpayers earning business income and the rules appertaining to them; 2) the meaning of gross income from business; 3) the distinctions between gross income from business and income from other categories; 4) the taxability of special receipts; and, 5) the concept of net income.

With respect to Deductions, the following were discussed: 1) the deductions available depending upon the status of

the taxpayer; 2) the general limitations and requirements necessary to qualify expense and loss items for deduction in computing gross business income; and 3) the specific deductible and non-deductible items.

Regarding Depreciation and Amortization, both legal and accounting concepts were discussed in order to present a complete picture of the various modes by which capital assets are depreciated and amortized in the countries under comparative analysis.

As to Net Loss from Operations, the work delves into the deductibility of the over-all loss of a taxpayer in a taxation year and the concepts of loss carry-forward and loss carry-backward.

The last part, Analysis and Conclusion, summarizes the work, points out the previously discussed similarities and divergence in tax concepts among the countries under comparative analysis, and, on the basis of economic and legal principles, submits specific suggestions and recommendations to improve the tax treatment of business income in France, the United States, Canada, and the Philippines.

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JOSE E. SABATER

TABLE OF CONTENTS

Page

I. INTRODUCTION 1-4

II. BUSINESS INCOME: TAX CONSEQUENCES AND MEANING 5-176

A. PRELIMINARY STATEMENT 5

B. TAXPAYERS EARNING BUSINESS INCOME ... 5-63

1. Business Income and Individuals as Taxpayers 5-36

a.) General Discussion .. 5-20

b.) Liability of Residents 20-23

i.) Citizens 20-22
ii.) Aliens 22-23

c.) Liability of Non-residents 23-36

i.) Citizens 23-27
ii.) Aliens 28-36

2. Business Income and Corporations as Taxpayers 36-55

a.) General Discussion...36-44

b.) Liability of Domestic Corporations 44-52

c.) Liability of Foreign Corporations.....52-55

3. Business Income and Unincorporated Entities as Taxpayers 55-63

C. GROSS BUSINESS INCOME..... 63-125

1. General Discussion..... 63-81

Page

2. Gross Income From Business Defined.....81-121

3. Items Excluded from Gross Income.....121-125

D. GROSS BUSINESS INCOME DISTINGUISHED FROM OTHER CATEGORIES.....125-137

E. TAXABILITY OF SPECIAL RECEIPTS.....137-174

1. Accumulated Profits 137-141

2. Receipts of Personal Holding Companies 141-148

3. Receipts of Investment Companies 148-157

4. Receipts of Banks 159-160

5. Receipts of Insurance Companies 160-172

6. Receipts of Private Educational Institutions ... 172-174

F. NET BUSINESS INCOME 174-176

III. DEDUCTIONS 177-360

A. DEDUCTIBILITY OF ITEMS DEPENDING UPON TAXPAYER.....177-179

B. THE CONCEPT OF INCOME-CONNECTED DEDUCTIONS AND ITS LIMITATIONS.....179-221

C. SPECIFIC DEDUCTION ITEMS 221-360

1. Initial and Operational Expenses.....221-280A

a.) Organization Expense.....221-225

b.) Compensation for Services Rendered.....225-236

Page

c.) Rent 236-242
d.) Repairs and Maintenance.....242-250
e.) Insurance Premiums.....250-255
f.) Travel and Entertainment....255-270
g.) Business Gift....270-272
h.) Fees.....273-278
i.) Expenses to Restrict Competition.....278-280A

2. Retirement and other Benefits 280A-288

3. Interest .....288 -301

4. Dividends .....301 -306

5. Bad Debts .....306 -315

6. Contributions and Research Expenses .....316 -327

7. Losses .....327 -347

8. Depletion .....347 -353

9. Taxes .....353 -360

IV. DEPRECIATION AND AMORTIZATION.....361-390

V. NET LOSS FROM OPERATIONS 391-400

VI. ANALYSIS AND CONCLUSION 401-447

FOOTNOTES 448-487

BIBLIOGRAPHY 488-490

I. INTRODUCTION

In this modern age of space satellites and guided missiles, more and more persons of divergent nationalities agree to trade and engage in commerce. In the process of deciding whether or not one should embark on a business venture in a particular country, the aspect of income taxation is always considered. There is, therefore, a need for tax lawyers to possess a working knowledge of the tax treatment of business income, in numerous, if not, all nations.

This thesis is a comparative analysis of the tax treatment of business income in France, the United States,[1] Canada, and the Philippines.

Let us now discuss the salient features that led to the choosing of the nations mentioned as the prime specimens of this comparative analysis.

FRANCE

France is well geographically situated in continental Europe and is a member of the European Common Market. It is an industrialized country under a civil law system. Its tax rules are based on a code systematically arranged and is not a mere compilation of general principles. Every aspect of taxation is covered in detail by legislation. Courts do not formulate rules but are simply required to

apply the provisions of the Code to factual situations. Judicial interpretations of codal provisions are only resorted to in cases of ambiguity.

The rules regarding income taxation are found in the Code General des Impots,[2] court decisions interpreting or applying the provisions of the same, and administrative decrees having the force of law.

UNITED STATES

The United States is located in North America. It is, presently, considered the most industrialized nation in existence. Although it is a common law country, its federal tax rules are codified in a systematic manner. Its Internal Revenue Code is so detailed and is also designed to cover all facets of taxation. As in France, the courts simply apply the legal provisions to controversies that arise and rarely formulate rules.

The tax rules are found in the Internal Revenue Code of 1954, as amended;[3] treasury regulations, administrative rulings, and judicial decisions applying or interpreting tax statutes.

The United States tax structure is different from France. In the U.S., income is not categoried into various classes. Moreover, with respect to the taxation of individuals, the main criterion for the determination of liability

is citizenship. The concept of residence is utilized only with respect to aliens. In the case of corporations, the important factors are the "place of incorporation" and whether they are domestic or foreign. All of these will be discussed later.

PHILIPPINES

The Philippines is a developing country with a bountiful supply of mineral resources. It is located in the center of Southeast Asia. It is a civil law nation utilizing American common law tax concepts. Subject to certain exceptions linked with its civil law background, there is almost no difference between the U.S. and the Philippine tax systems.

The Philippine rules on taxation are found in the National Internal Revenue Code of 1939, as amended,[4] revenue regulations, administrative rulings, and court decisions. It should be noted that decisions of judicial authorities in U.S. interpreting similarly worded tax provisions are given much weight by Philippine Courts.

CANADA

Canada is a wealthy developing nation. It is a common law country strategically situated in the North American continent. Its tax system is basically identical to that of England. The Canadian Income Tax Act[5] is different in that it

is not comprehensively arranged to cover the various details of taxation. It is simply a compilation of general principles. The courts usually provide the particulars necessary for the proper implementation of the ITA. In this regard, Canada relies heavily on English jurisprudence.[6] However, U.S. judicial decisions are also considered in connection with the interpretation of statutory provisions adopted from the United States.[7]

The Canadian rules on taxation are found in the ITA, revenue regulations, administrative adjudications, and case law.

II. BUSINESS INCOME: TAX CONSEQUENCES AND MEANING

A. PRELIMINARY STATEMENT

A thorough analysis of business income requires the discussion of the following: 1) the business income earned by various classes of taxpayers and the rules appertaining to them; 2) the meaning of gross income from business; 3) the distinction between gross income from business and income from other categories; 4) the taxability of special receipts; and, 5) the concept of net income.

B. TAXPAYERS EARNING BUSINESS INCOME

Whether in France, U.S., Philippines or Canada, there are generally, three types of taxpayers earning business income. They are: 1) individuals as single proprietors; 2) corporations; and, 3) non-incorporated entities doing business.

1. Business Income and Individuals as Taxpayers

a) General Discussion

FRANCE

In France, an individual may, subject to various formalities, create or purchase a business without incorporating.[1] He is, thus, doing business as a sole proprietor (enterprise individuelle). Such a proprietor has sole responsibility for the business in which he engages and all his assets, both business and personal, are subject to being attached

to pay his debts.[2]

The individual income tax is levied annually, at progressive rates, on taxable income. Under Article 197-1, CGI, the rates range from 5% for income not exceeding 2,400 Francs up to 66.5% for income exceeding 72,000 Francs.

As will be discussed later, individuals earning income that fall under Articles 34 to 36, CGI, are subject to business income tax.

For tax purposes, individuals are classified into residents or non-residents.

Fiscal "residence" (unless specified, "domicile" and "residence" are used in the same context) for tax purposes is not necessarily determined by the same tests used to ascertain domicile under Articles 102 and 103 of the French Civil Code.[3] The Civil Code provides that the domicile of a Frenchman is the place in which he has his principal establishment, and that change of domicile is accomplished by the creation of habitation in another place with the intention of making it the principal establishment.

In determining residence for tax purposes, facts outweigh intentions.

According to a decision of the Conseil d'Etat (Council of State), C.E. 11 March 1964, No. 55, 305, the tax rules governing the determination of the residence of aliens are

to be applied in cases involving French citizens. Hence, in France, as a general rule, there is no necessity to distinguish between citizens and aliens in connection with residence.

There are two tests for the determination of residence in France. They are i) the "center of interests" test; and, ii) the principal residence test.

The "center of interests" test determines the residence of an alien by the location of his economic interests. The test is described as follows: "An alien who carries on economic activities in France will be deemed to have his domicile in France if those activities are his major activities and have a character of permanence and stability."[4]

In C.E. 21 January 1963, No. 46, 547, the evidence showed that an alien lived in Paris since 1946, rented an apartment in 1949, and carried on commercial activity in France either personally or through a Lebanese company wholly under his control. It was held that he was domiciled in France for income tax purposes.

If an individual carries out no economic activity in France, the location of the main portion of his wealth is the criterion for determining the "center of his interests".[5] Certainly, there can be no problem in the determination of the location of fixed assets or real properties.[6] The dif-

ficulty is in fixing the location of securities or choses in action.[7]

In C.E. 17 January 1962, No. 49, 391, it was held that the physical location of the securities, rather than the place from which the portfolio is managed, determines the "center of interests". Here, the alien kept his portfolio abroad and managed it from France. The alien was deemed not to have his center of interests in France. As a consequence, he was not considered as domiciled in France. The same principle was applied in C.E. 9 December 1964, No. 50, 346.

Lastly, it should be noted that even if another country considers an alien as domiciled therein, this does not affect the "center of interests" test.[8] The alien concerned may still be considered as domiciled in France for tax purposes.

Even if the center of a person's economic interest is not in France, under Article 164-1, CGI, he will be considered as domiciled in France if he has made his principal residence in said country for more than five years. This is the "principal residence" test.

In C.E. 20 February 1961, No. 50, 457, an alien arrived in France in 1947. After some preliminary stay in a hotel, he rented an apartment. From 1948 to 1955, he spent at least six months each year in France. It was held that he

was domiciled in France at the expiration of the five year period from his arrival.

UNITED STATES

The federal income tax is imposed upon individuals and computed in accordance with the schedule of progressive rates set forth in Section 1, IRC. The rates differ in application depending on whether the individual is a citizen or alien, and upon the taxpayer"s family status.

Pursuant to Section 1(a), IRC, the rates, subject to certain exceptions with respect to non-resident aliens, range from 20% for income not exceeding $2,000 up to 91% of $200,000 and over. However, the tax is subject to a maximum effective rate limitation of 87%.

Like France, the income of a sole proprietorship in the United States is taxed directly to the individual proprietor.

In computing his own taxable income for the year, "the proprietor will aggregate proprietorship net income with income from all other sources, including the net income of any other proprietorship which he may own."[9] If there is a net loss for the year, the loss will be considered as incurred directly by the proprietor and "will be an offset against income received by him from other sources."[10]

Unlike France, the main criterion for determining

the tax liability of individuals in U.S. is citizenship rather than residence.

Citizens of U.S., wherever resident, are subject to tax on their income from all sources whether domestic or foreign. Thus, residence is not taken into account in fixing the tax liability of citizens. The question of citizenship is resolved under the political laws of the United States.

Residence is only considered for purposes of taxing aliens. Section 1.871-1, Revenue Regulations, states:

> "Nonresident alien individual means an individual (a) whose residence is not within the United States and (b) who is not citizen of the United States. Any alien living in the United States who is not a mere transient is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to his stay. If he lives in the United States and has no definite intention as to his stay, he is a resident. The best evidence of his intention is afforded by the conduct, acts and declarations of the alien. The typical transient is one who stops for a short time in the course of a journey through the United States, sometimes performing labor, sometimes not, or one who enters the United States intending only to stop long enough to carry out some purpose, object or plan not involving an extended stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient."

An alien not falling under the above meaning of "nonresident" is a resident alien.

In Bowering v. Bowers,[11] the taxpayer was born in Newfoundland. However, he went to school In England where his family subsequently lived after disposing of their property and house in Newfoundland. At the age of 24, he was assigned to the family business in U.S. The taxpayer married an American, and maintained two houses in Manhatten and Staten Island. He lived in leased houses for 19 years until he bought the last house he was leasing. During a period of 27 years, 22½ years was spent in the U.S. and the rest in England. His average continuous stay in U.S., at any one time, was computed at a little less than 4 years. On the other hand, his average for England was only from 5 to 4 months. In his will and baggage declarations, he stated that he was from the city of Liverpool and registered himself and his children as British subjects. The Court of Appeals affirmed the finding of the Tax Court that the taxpayer was a "resident" of U.S. for income tax purposes in accordance with Section 1.871-1 of the Regulations.

It is settled that residence for purposes of income tax is not equivalent to the term domicile.

In Myers v. Commissioner,[12] the Court of Appeals said: "It is quite clear that, in the tax statute before us (Sec. 116(a) dealing with exclusion of earned income from taxable income of American citizens bona fide residents

abroad) residence is used in the limited sense as contrasted, rather than synonymous, with domicile." The same Court, in Commissioner v. Swent,[13] stated: " 'Residence' simply requires bodily presence as an inhabitant in a given place, while 'domicile' requires bodily presence in that place and also intention to make it one's domicile."

Once "residence" is established, it is a uniform rule in U.S., that short pleasure or business trips back to the taxpayer's own country do not interrupt such residence.[14]

PHILIPPINES

There is no difference with respect to the concept of a single proprietorship in the Philippines, the United States and France.

The income tax imposed on the individual proprietor is computed in accordance with the schedule of progressive rates provided in Section 21, NIRC. The rates, subject to certain exceptions with respect to non-resident aliens, range from 3% for income not over ₱2,000 up to 70% of income over ₱500,000.

The main criterion for determining the tax liability of individuals in the Philippines is the same as that in the United States. The emphasis is on citizenship rather than residence. The citizenship of a person is ascertained in accordance with the Philippine Constitution.

The concept of residence is only utilized for the purpose of fixing the tax liability of aliens. Section 84(e), NIRC, defines the term "resident" as "an individual whose residence is within the Philippines and who is not a citizen thereof", and a "non-resident" as an "individual whose residence is not within the Philippines and who is not a citizen thereof".

Section 5, Income Tax Regulations, provides:

> "An alien actually present in the Philippines who is not a mere transient or sojourner is a resident of the Philippines for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to the length and nature of his stay. A mere floating intention indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the Philippines and has no definite intention as to his stay he is a resident. One who comes to the Philippines for a definite purpose which in its nature may be promptly accomplished, and to that end the alien makes his home temporarily in the Philippines, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned."

Section 6 of the Regulations also states:

> "An alien who has acquired residence in the Philippines retains his status as a resident until he abandons the same and actually departs from the Philippines. An intention to change his residence does not change his status as a resident alien to that of a non-resident alien. Thus, an alien who has acquired a residence in the Philippines is taxable as a resident for the remainder of his stay in the Philippines.

Philippine Courts have not yet directly made a ruling

on "residence" or "non-residence" in relation to income taxation.

In Collector v. de Lara,[15] it was held that the term "resident" as used in the income tax law has a different connotation for purposes of transfer taxes. As to transfer taxes, the term is synonymous and in fact interchangeable with the term "domicile". This was an estate and inheritance tax case. It was established that the deceased, Hugo Miller, never acquired a house for residential purposes in the Philippines. He stayed at the Manila Hotel and later on at the Army and Navy Club. Except for occasional visits, his wife never stayed in the Philippines. The bulk of his savings and properties were in the United States. To his home in California, he had been sending souvenirs, such as carvings, curious and other similar collections from the Philippines and the Far East. In 1940, Miller took out a property insurance policy and indicated therein his address as Santa Cruz, California. In his will, Miller stated also that he was "of Sta. Cruz, California". In 1944, the deceased died in the Philippines in the custody of the Japanese army. In holding that the deceased was not domiciled in the Philippines for purposes of determining the estate and inheritance tax liability, as dinstinguished from the meaning of "residence", under Section 5, Income Tax Regula-

tions, the Tax Court said:

> "We find this contention without merit. Firstly, the aforecited regulation is self-limiting, in that it was intended to apply to income taxes and promulgated to implement the income tax law, not the estate and inheritance tax law. Secondly, the meaning of the term "residence" for purposes of the estate tax should be distinguished for its meaning for purposes of the personal income taxes."

The Supreme Court affirmed the Tax Court on this issue.

It should be emphasized that the provisions regarding the determination of "residence", under the NIRC and the Income Tax Regulations, are substantially identical to those in the United States. Hence, the persuasive value of U.S. Court decisions, in this regard, cannot be disregarded.

CANADA

Operating a business under a single proprietorship is no different in Canada as compared to France, U.S., and the Philippines.

The income of proprietors (individuals) is taxed at rates set forth in Section 32 (1), ITA. The rates range from 11% on taxable income less than $1,000 to 80% on taxable income over $400,000. Section 104B, ITA, also requires the individual proprietor to pay a social development tax for the year equal to the lesser of 2% of his taxable income as determined under part I, or $120. Section 10 of

the Old Age Security; R.S.C. 1952, Chap. 200, imposes an added tax of 4% on investment income from sources outside Canada in accordance with Section 32(3) to (5), ITA.

As in France, "residence" is the deciding factor in fixing the tax liability of an individual. "Citizenship" is not considered as significant.

It is difficult to give a precise definition of the term "resident" under Canadian jurisprudence. The Income Tax Act does not give any definition of it.

Under Section 2, ITA, it is simply provided that an income tax shall be paid upon the income of "every person resident in Canada at anytime in the year."

Section 139 (4), ITA, provides that "resident" includes a person who was at the relevant time "ordinarily resident in Canada." Decisions of the Tax Appeal Board and the Exchequer Court indicate that "ordinarily resident in Canada" should be regarded as broader in connotation than "resident in Canada."[16]

Section 139 (3), ITA, appears to have given a broader scope to the meaning of "resident". It states that a person shall be deemed a "resident of Canada" throughout a taxation year if i) he sojourned in Canada in the year for a period or periods, the aggregate of which is 183 days or more; ii) he was, at any time of the year, a member of the

naval, military or air force of Canada; iii) he was at any time in the year, a) an ambassador, minister, high commissioner, officer or servant of Canada, or b) an agent-general, officer or servant of a province, and was resident in Canada immediately prior to appointment or employment by Canada or the province or received representation allowance in respect of the year; iv) he (or she) was at any time in the year living with an aforementioned member of the armed forces or public service as that member's spouse, provided he was sometime previously resident in Canada; or, v) he was at any time in the year the dependent child of such aforementioned member of the armed forces or public service.

Under Section 139 (3a), ITA, a member of the armed forces or public service together with his spouse and dependent children, upon such person ceasing to be "a person so described", are "deemed" to have been resident in Canada only during the part of the year preceeding the time when he ceased to be "a person so described".

The provisions mentioned above are the basic general principles which Canadian Courts utilize to determine whether or not a person is a "resident" or "ordinarily resident" in Canada.

In Avent v. M.N.R.,[17] a Royal Canadian Air Force officer on duty overseas lived in rented quarters without

maintaining a home in Canada. The said facts taken in conjunction with other corroborative facts led to the decision that the officer was "ordinarily resident" of Canada. Russell v. M.N.R.,[18] on the other hand, declared that, if a person maintains a home in Canada during his absence, it is easy to conclude, by taking into account other supporting facts, that he is a resident of Canada.

In Thompson v. M.N.R.,[19] a Canadian left Canada and declared his intention to establish his home and domicile in Bermuda. He lived away from Canada for 183 days each year. However, yearly, he returned to Canada for substantial periods during which he played golf with friends and lived in a huge house that he owned and maintained in New Brunswick. The Supreme Court held that he was a resident of Canada for tax purposes.

In Schujan v. M.N.R.,[20] an employee of a U.S. corporation was transferred from Minneapolis to Toronto. He and his family purchased a house in Toronto and lived there for several years. Thereafter, he returned to the United States as assistant to the vice president of his firm. In the United States, he bought a house and tried to rejoin his former club. His wife and children remained in Canada to sell their house. The taxpayer continued to maintain a car in Toronto for the use of his family. Bank accounts in his

name were also maintained for the purpose of paying his mortgage obligations and the household expenses of his wife and children. While residing in the United States, he returned to Canada only thrice. The first was when he passed by Toronto on his way to England on a business trip. The second was when he went back to the United States from England. His third visit was when he spent his Christmas vacation for a week with his family in Toronto. On the basis of the foregoing facts, it was held that when he returned to the United States, after August 2, 1957, he was no longer a resident of Canada for tax purposes.

Truly, the problem of determining whether a person is a "resident", "ordinarily resident", or "non-resident" is one that must be resolved by considering all the material facts obtaining in each case. The fact that a person bought a house in Canada, by itself, would not conclusively establish that he is a "resident" of Canada. Likewise, an individual would not be considered a "non-resident" simply because he sold his home upon leaving Canada. Other facts, such as whether or not he maintained bank accounts in Canada after his departure, whether or not his family remained in Canada while he was abroad, whether or not he severed his connections with social and professional clubs in Canada, whether or not he joined social or professional

clubs in the place where he went, whether or not he returned to Canada after his departure, must be taken into account. In short, no single fact is sufficient to constitute a person as a "resident", "ordinarily resident" or "non-resident" of Canada. All the facts indicating the intention of a person to remain as "resident" or be "ordinarily resident" of Canada should be grouped together and carefully weighed against all the facts showing an intention to be a resident of some other country. Only after balancing which is more weighty between the two opposing groups of facts can a conclusion be made as to whether or not a person is a "resident", "ordinarily resident" or "non-resident" of Canada.

Lastly, it should be noted that the meaning of the term "residence" under the Income Tax Act is different from "domicile" as understood in connection with death duties.[21]

b) Liability of Residents

Residents could be either citizens or aliens. Let us now compare the income tax liability of citizens and aliens in the countries under analysis.

i) Citizens[22]

FRANCE

A French citizen residing in France is subject to tax on business income from all sources, whether foreign or domestic.[23]

Under Article 166, CGI, a non-resident citizen who transfers his residence to France is also subject to tax on income earned from foreign and domestic sources from the date of his transfer within the taxation year.

UNITED STATES

As already explained, American citizens residing in the United states are also subject to tax on their net world-wide business income (foreign and domestic).[24] Thus, in this connection, there is no difference between France and the United States. However, in the United States, the rules regarding "part-time residence" are applicable only to aliens.

PHILIPPINES

The rules with respect to the income taxation of Filipino citizens are similar to those applicable to American Citizens. In this regard, Section 21, NIRC, provides that the rates mentioned under it are imposable upon the net income of citizens, whether foreign or domestic, residing in the Philippines. As in the United States, the rules on "part-time residence" are applicable only to aliens.

CANADA

Section 2, ITA, provides that tax should be paid on the taxable income for each taxation year of every person resident in Canada at any time in the year. Section 3, ITA, states that the income of a taxpayer for a taxation year is

the income from all sources inside or outside Canada. Thus, in this respect, there is no difference whether in Canada, France, the United States, or the Philippines.

As in France, in Canada, the universal tax liability of a citizen extends only to the period he is a resident of Canada in a taxation year.[25]

ii) Aliens

FRANCE

As a general rule, since the criterion for the determination of tax liability in France is residence rather than citizenship, the fact that a resident is an alien or citizen is of no legal consequence. However, if the foreign source income of a resident alien is subject, in the country of which he is a citizen, to a personal income tax on his total income, he is subject to tax only on his business income from French sources.[26] In this respect, an alien in France is better treated than a French citizen.

UNITED STATES

In the United States, the rules on the tax liability of citizens are applicable to resident aliens. Hence, the resident alien is, subject to the exception respecting income for which tax has already been paid in a foreign country where it was earned, taxable on his income from all sources.[27] It should be noted that the exception pointed to above is applicable only to resident aliens who are citizens of

countries having tax treaties or reciprocal arrangements with the United States involving the matter.

PHILIPPINES

As in the United States, the rules on the tax liability of citizens in the Philippines are also applicable to resident aliens. Thus, resident aliens are also subject to tax on income from local and foreign sources.[28]

CANADA

Resident aliens in Canada are also subject to tax on income from all sources. The reason for this is the fact that Section 2, ITA, speaks of the liability of residents regardless of whether the person is a citizen or an alien.

c. Liability of Non-residents[29]

Non-residents could also be classified as either citizens or aliens.

i) Citizens

FRANCE

A citizen who is not a resident of France is, under Article 165-1, CGI, liable for tax only on business income realized by him in France. He is not liable for income from foreign sources. Thus, it is important to know the meaning of "income realized from business in France".

A non-resident citizen will be regarded as carrying on business in France if he has a permanent establishment of

a profit-making character in the country. Under the said test, two conditions must be met: i) there must be a place of business in France with some degree of autonomy and permanence; and, ii) the place of business must be productive in nature of a kind to contribute to business earnings.[30]

In R.M. 7, 181, J.O. 8 April 1934, Deb. Ch., p. 1063, an Algerian firm rented warehouses in France. The warehouses were managed by a French firm holding the exclusive agency to sell the Algerian firm's products. It was held that the warehouse constituted a taxable establishment in France. A French sales office with a selling organization of some sort is also regarded as an establishment carrying on taxable activity in France.

"Productive in nature" is described as follows: "The French installation need not engage in operations that directly produce profit ...; it is enough that the activity of the installation, even though preliminary or auxilliary, is of such a nature that it will eventually add to the profitability of the parent enterprise."[31] Thus, in R.M. 1,796, J.O. 24 March 1933, Deb. Sen., p. 578, an office set up to study and research on the French Market was held to be a taxable establishment.

UNITED STATES

Unlike France, non-resident citizens of the United States are subject to tax on business income irrespective of whether the source is foreign on local.[32] However, under Section 911, IRC, a citizen, living permanently or temporarily in a foreign country, is exempt from tax on foreign source earned income attributable to services performed to the extent of $20,000 in any taxable year. In accordance with Section 911 (a)(1) and 911 (c)(1), IRC, if the citizen has been a foreign resident for an uninterrupted period of three consecutive years, the maximum annual exclusion is $35,000.

It should be noted that, unlike France, there is no need to determine whether or not a non-resident citizen is engaged in business activity in the United States. The reason is simply that in the United States the tax liability of a citizen is for income, both from foreign and local sources, and not only for income arising from business activity in the country.

PHILIPPINES

Non-resident Filipino citizens are also subject to tax on both foreign and domestic business income. This is clearly specified in Section 21, NIRC, which states that a tax is imposed on the net income from all sources received

during each taxable year by a citizen residing abroad. The only difference between the United States and the Philippines, in this regard, is that Filipino citizens are not granted the partial tax exemption, available to American citizens, on foreign source income attributable to services performed.

CANADA

As in France, the tax liability of a Canadian citizen who is a non-resident, under Section 2 (2)(b), ITA, extends only to his taxable income earned from business carried on in Canada at any time of the year.

Section 139 (1)(e), ITA, clarifies the meaning of "carrying on business". It provides that "business includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or undertaking in the nature of trade but does not include an office or employment. Hence, if the activities of the non-resident Canadian citizen involve any of the types mentioned above as constituting business, then he is deemed to be "carrying on business". This matter will be discussed in detail when "gross income" is considered.

Aside from the "carrying on business" requirement, to qualify a non-resident citizen for tax liability, it is also necessary that the business be "carried on in Canada." Section 139 (7), ITA, considers a non-resident citizen as

carrying on business in Canada if in any taxation year he "(a) produced, grew, mined, created, manufactured, fabricated, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not he exported that thing without selling it prior to exportation, or (b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada." Consequently, if the activities of the non-resident fall under the terms of Section 139 (7), he shall be considered as carrying on business in Canada.

It should be emphasized that under Section 106, ITA, a non-resident is liable to "pay an income tax of 15% on every amount that a person resident in Canada pays or credits or is deemed by Part I to pay or credit to him as, on account or in lieu of payment of or in satisfaction of", management fees; interests; estate or trust income; rents, royalties, and similar payments; timber royalties; alimonies; patronage dividends; and, certain specific dividends. This tax is in addition to the tax determined in accordance with the progressive rates under Section 32. In this regard, there is a proposal pending before the Canadian Parliament to increase the withholding rate from 15% to 20%.[33]

ii) Aliens

FRANCE

The rules regarding the business income tax liability of non-resident citizens and non-resident aliens are, as a general principle, identical. There is only one significant difference. A non-resident alien who maintains a home in France is not entitled to the benefits of the family-quotient system.[34] Nevertheless, a non-resident alien without a home in France who is required to file an income tax return may split his income into two parts for purposes of computing his tax.[35] The splitting is permitted irrespective of his family status and despite the rule that only French citizens may use the family-quotient system.[36]

UNITED STATES

As in France, non-resident aliens in the United States are only subject to tax on income arising out of business carried on in the United States.

What constitutes "engaging in trade or business in the United States"?

In European Naval Stores Company v. Commissioner,[37] it was held that one unauthorized transaction by a controlled subsidiary in the U.S. did not constitute doing business by the foreign corporation.

Commissioner v. Nubar[38] illustrates the rule that

extensive activity, as an element of "continuity" is an index of being engaged in "trade or business". Nubar was a wealthy Egyption stranded in U.S. during World War II. He traded in the stock exchanges and derived profits exceeding $600,000. When the profits were taxed, his defense was that he was a non-resident alien not engaged in trade or business in the United States. Since U.S. statutes did not tax non-resident aliens on their capital gains, he claimed that he had no deficiency tax liability. The Court of Appeals in deciding the case for the Government said:

> "And we think it equally clear that the taxpayer was engaged in business within the United States within the meaning of the statute and was not taken out of the category because the business resulted in purchases and sales effected through resident brokers. The provision as referred to ... was inserted in the statutes to exempt those transactions in securities or commodities whose sole connection with business in the United States was the activity of the broker. This is not the case here. The brokers merely carried out for the taxpayer the purchases and sales which he determined upon in the course of the trading in which he himself was engaged. This involved ... the forming of judgements and the making of decisions with regard thereto; and these were made by the taxpayer in the exercise of his business judgement, just as any other trader in the United States, before the orders to buy or sell were communicated to the brokers ..."

In another case,[39] the Court of Appeals held that a non-resident alien, though outside the United States, was engaged in trade or business in U.S. because of the

extensive trading in securities effected by a brother, present in the country, through different brokers.

There is another dominant element involving the concept of "engaging in trade or business". It is called the "active pursuit of profits factor, although actual profits need not be realized. This element sets investment activities apart from acts constituting "carrying on business" for the former does make one "engaged in trade or business".

Thus, a real estate corporation leasing and selling land, operating his own property, and making its own exploration work was considered as carrying on trade or business rather than investment activities. The Court declared that "investment" is the owning and holding of property, and the distribution of the fruits or avails is an "act of ownership"; on the other hand, continued efforts in pursuit of profit proves that the operation is for profit so as to classify it as "business".[40]

In a case,[41] a non-resident decedent who operated eleven buildings in New York through an agent and attorney-in-fact was considered as engaged in business in the United States. The decision was based on the distinction between "investment and reinvestment of funds" and "management of the real property for profit". Nevertheless, the lease of

an operating railroad to another on a net rental basis, the owner not doing anything more, was held to be not "engaging in trade or business".[42] However, it was declared by the U.S. Tax Court that a foreign investment corporation operating the farms and ranches it acquired through mortgage foreclosures constituted engaging in trade or business.[43] The basis of the decision was "the management of the property by the principal and its agents" as distinguished from cases where non-resident owners and lessors of property in the U.S. merely received rents while the tenants managed, maintained or operated the same.

Another question that must be considered is the place where the business or trade activity is performed. To render the non-resident alien liable for tax, the activities must be conducted in the United States.

The maintenance of an "office or place of business" test is no longer a significant factor in ascertaining the place where the business or trade activities are performed.[44] Thus, in Commissioner V. Scottish American Investment C. Ltd.,[45] it was held that the mere maintenance of an office is not conclusive, even where it was kept to service investments or sporadic investments.

The procedure in determining the place of "trade or business" is conducted through an examination of all the

acts and contracts of the non-resident alien. The Courts do not hesitate to make a finding that there is "engaging in trade or business" where transactions were recurring and extensive.[46] Licensing to do business also carries a heavy weight, unless no activities were actually performed.[47]

The "locus of managerial discretion" rule is also utilized in the United States. The rule simply means that the place where managerial discretion is exercised is the place where the trade or business is performed. The Nubar case, which was discussed earlier, aptly exemplifies the application of the rule.

Thus, the determination of the place where the business or trade is conducted depends upon the facts of each particular case.

It should be noted that non-resident aliens not engaged in business in the United States are taxed on gross income at different rate levels depending upon the total income for the taxable year.[48]

PHILIPPINES

Section 22, NIRC, provides that a tax "shall be levied, collected, and paid for each taxable year upon the entire net income received from all sources within the Philippines by every non-resident alien individual engaged in trade or business within the Philippines ..." Thus, the rule on

source liability obtaining in France and the United States also applies to non-resident aliens in the Philippines.

Under Section 22, in order to render a non-resident alien liable for tax, the following should concur: i) he is engaged in trade or business; and, ii) the trade or business is conducted within the Philippines. These will be discussed in turn.

What is the meaning of "engaged in trade or business" under the NIRC?

Section 22 provides that a non-resident alien individual who shall come to the Philippines and stay therein for an aggregate period of more than one hundred eighty days during any calendar year shall be deemed a non-resident alien doing business in the Philippines. Thus, even if the non-resident alien does not do anything, he is considered to be doing business in the Philippines if he stays in the country for an aggregate period of more than one hundred eighty days during any calendar year. This presumption as to doing of business in the Philippines does not exist in France, the United States, and Canada.

However, if the non-resident alien stays in the Philippines for an aggregate period of 180 days or less, when shall he be considered as "engaged in trade or business"?

Section 8, Income Tax Regulations, provides:

> "The phrase 'engaged in trade or business within the Philippines' includes the performance of personal services within the Philippines ...."

The said Regulation is not of much help. Thus, Philippine Courts have resorted to U.S. cases interpreting revenue regulations and statutory provisions similar to those obtaining in the Philippines.

In Brillo v. Commissioner,[49] the Tax Court, citing U.S. authorities, said: "The word 'engaged' connotes more than a single transaction; it involves some continuity of action." The Supreme Court, in Imperial v. Collector,[50] quoting U.S. cases, also stated:

> "To 'engage' is to embark in a business or to employ oneself therein. (Webster's New Int'l. Dict.) The word 'engaged' connotes more than a single act or transaction; it involves some continuity of acting ..." 'To engage in business is uniformly construed as signifying to follow the employment or occupation which occupies the time, attention and labor for purpose of a livelihood or profit. ... The expression 'engage in business' do not have different meanings, but separately connectedly convey the idea of progression, continuity or sustained activity, and 'engaged in business' means 'occupied or employed in business'; 'carrying on business' does not mean the performance of a single disconnected act, but means conducting, promoting, and continuing business by performing progressively all the acts normally incident thereto, while 'doing business' conveys the idea of business being done, not from time to time, but all the time."

As can be gleaned from the foregoing, the Philippines, as the United States, adopts the "continuity of activity" and the "active pursuit of profits" tests.

The next question deals with whether the activity which constitutes engaging in trade or business is conducted in the Philippines. As in the United States, the answer depends upon the material facts in every case.

In General Corporation of the Philippines, et. al. vs. Union Insurance Society of Canton Ltd.,[51] it was held that a non-resident alien is said to be "engaged in business in the Philippines" when there is continuity of conduct and intention to establish a continuous business, such as the appointment of a local agent, and not of a temporary character.

A resident manager of the Quantas Empire Airways, Ltd., in Manila was considered to be a non-resident alien engaged in business in the Philippines.[52] It was also held that a non-resident alien is deemed engaged in business in the country if he derives rental income of ₱4,000.00 or more annually.[53] It is possible that the "locus of managerial discretion" rule will also be applicable in the Philippines considering that the wording of the statutory provisions and the regulations on the subject in the Philippines and the United States are similar.

Regarding the treatment of non-resident aliens not "engaged in trade or business in the Philippines", as in the United States, suffice it to say, that, they are taxed

at different rates depending upon the total annual gross income.

CANADA

Section 2 (2) (b), ITA, imposes a tax upon the taxable income of any non-resident, regardless of whether a citizen or an alien, who carries on business in Canada at any time of the year. In accordance with said provision, for business income tax purposes, there is no difference between the treatment of a non-resident citizen and non-resident alien. Thus, the rules on non-resident citizens previously discussed are applicable to non-resident aliens.

2. Business Income and Corporations as Taxpayers

a) General Discussion

FRANCE

Corporations are considered as distinct and separate entities for purposes of income taxation under the French Tax Code.

In France, the nature of a corporation is described as follows: "The French corporation known as the societe anonyme is very similar to an American corporation. It is an artificial being brought into existence by contract of the incorporators; death or bankruptcy of a shareholder does not affect its existence. The holder of or subscriber to shares has no personal liability to creditors of the

corporation except to the extent of any unpaid consideration for which share were issued. In other words, creditors can attach all of the assets of the corporation and thereby extinguish the interests of shareholders, but personal assets of the shareholders cannot be reduced."[54]

Corporations can be classified as foreign or domestic.

The location of the siege social (head office) of a corporation determines whether it is to be taxed as a domestic (French) or a foreign entity in France.[55]

The nationality of the owners or the place of incorporation are not considered in determining the tax liability of a corporate entity.[56] This is explained as follows: "The corporation law requires that the charter of a corporation incorporated in France designate a place in France as the head office. The head office designated in the charter... is presumed to be the head office for tax purposes. The presumption is rebuttable, however. If the facts show that the actual management is being carried on from another place, with the result that the charter head office is only fictitious..., the head office is the place in which the actual management is centered and from which it is carried on..."[57]

The siege social test under the French Tax Code is the same as that existing under the French Corporation Law.[58]

In accordance with the corporation law, the actual head

office is "the location of the principal administrative office of the company, from which directions emanate, rather than the place or places, where its operations are conducted."[59] Thus, in C.E. 3 March 1958, No. 41, 135, a shipping company maintained a registered head office out of France. It operated ships, registered out of France, plying only between foreign ports with freight bills paid out of France. However, administrative, commercial, accounting and technical services were handled in France. Foreign freight contracts were procured by independent agents abroad lacking power to bind the company. It was held that the company had its actual head office in France.

If the actual head office of a corporation is located in France, it is considered a domestic entity. Otherwise, the corporation is deemed a foreign entity.

A French corporation can become a foreign corporation by simply transferring its head office out of France.[60] Such transfers are, nevertheless, rarely done because it is regarded as a dissolution of the corporation, a process which may have serious tax consequences.[61]

UNITED STATES

In the United States, as in France, an enterprise that is formally organized as a corporation is almost always recognized as a separate taxpaying entity. However, the

separate identity of a corporation may be disregarded if the corporation lacks a substantial business activity, or if it was organized to enable the shareholders to avoid income taxes, and without substantial commercial purpose.[62]

Section 7761 (a) (3), IRC, defines the term "corporation" to include "associations, joint stock companies, and insurance companies."

In the United States, due to the above definition, courts are able, for tax purposes, to give a broader application to the term "corporation" -- an application which extends beyond the conceptual scope of the conventional chartered entity under corporation statutes. As a consequence, considerable litigations have arisen regarding the problem of distinguishing between corporations and other forms of business organizations.

In general, an organization is considered as an "association" if its "characteristics" are such that it more nearly resembles a corporation than a trust or a partnership.

Section 301.7701-2 (a) (1) of the Regulations provides that, ordinarily, the major characteristics distinguishing corporations from other organizations are: a) associates; b) an objective to carry on business and divide the gains therefrom; c) continuity of life despite the death or withdrawal of a participant; d) centralized management; e) lia-

bility for corporate debts limited to corporate property; and, f) free transferability. Accordingly, if a business organization, other than a corporation, possesses the characteristics mentioned, it will be considered as an "association" and, therefore, taxable as a "corporation".

In the United States, corporations are also classified as either domestic or foreign.

A domestic corporation is defined under Section 7701 (a) (4), IRC, as one "created or organized in the United States or under the laws of the United States or of any State or Territory". Created or organized "in the United States" means within the geographical limits of the District of Columbia and any of the States.

There is an apparent problem regarding the definition of a domestic corporation under Section 7701 (a) (4). Indeed, it is possible for a corporation to be "organized in the United States" under the laws of a foreign country. In a situation like this, what happens? It is now settled that the operative part of the definition given above is "under the laws of the United States or of any State or Territory". Consequently, a domestic corporation is one incorporated under the Laws of the United States or one of its States regardless of where the events leading to the incorporation took place.

Pursuant to Section 7701 (a) (5), IRC, a foreign corporation is any corporation which is not a domestic corporation. Thus, it is any corporation incorporated in a foreign country or possession of the United States which exists by virtue of the laws of the foreign country or the possession.

Hence, in the United States, the place of incorporation is a decisive factor in determining the source liability of a corporation. It does not use the "seat-of-management test", the rule applied in France, to delineate its jurisdictional reach over corporations.

PHILIPPINES

Since the Philippine Corporation Law is patterned after that of the United States, there is no difference between the concept and nature of a corporation in the Philippines and the United States.

However, under the NIRC, the definition of a "corporation" in the Philippines, as a separate taxpaying entity, is broader than that of the United States.

Section 84, NIRC, provides that the term "corporation" includes partnerships, no matter how created or organized, joint-stock companies, joint accounts (*cuentas en participation*), associations or insurance companies, but does not include duly registered general co-partnerships (*companias collectivas*). Thus, in the Philippines, there are forms of

business organizations subject to corporate tax aside from "joint-stock companies, associations or insurance companies".

In the Philippines, corporations are also classified into domestic and foreign. As in the United States, domestic corporations are those incorporated under Philippine laws; and, foreign corporations are those incorporated in accordance with the statutes of a foreign country. Thus, the accepted test in the Philippines is also the "place of incorporation" test rather than the "seat-of-management" test.

CANADA

Regarding the concept and nature of a corporation as a business organization, there is no difference between those in France, U.S., Philippines, and Canada.

The taxability of corporate income is based on Section 2, ITA, in relation to Section 139 (i) (ac), ITA.

Under Section 2, persons are subject to tax on income. In accordance with Section 139 (1) (ac), "persons" is defined to include any body corporate. Thus, corporations are subject to tax as entities distinct from the shareholders.

Section 139 (1) (h), ITA, provides that a "corporation" includes an incorporated company and a "corporation incorporated in Canada" includes a corporation incorporated in any part of Canada before or after it became a part of Canada. The above definition is narrower in scope as compared to the

meaning of "corporation" under taking statutes in France, U.S., and the Philippines.

With respect to a corporation not incorporated in Canada, for purposes of delineating the jurisdictional reach of the government over it, the accepted doctrine is the "control and management" test. It is similar to the "seat-of-management" test obtaining in France.

In Canada, the counterpart of a domestic corporation is the so-called "resident" corporation. The equivalent of a foreign corporation is the "non-resident" corporation. A corporation not incorporated in Canada is considered a "resident" if control and management are exercised in Canada. This rule was adopted from English jurisprudence.

In Egyptian Delta Land & Investment Co. Ltd. v. Todd,[63] it was declared that the residence of a company is where its main business is carried on. It was also pointed out that the main business is carried on where the central control and management is located.

Central control and management is normally located where the board of directors meet and make their decisions on company policy. In Unit Construction Co. Ltd. v. Bullock,[64] it was held that when the board of directors of a subsidiary corporation remained inactive, leaving the management and direction of the company to the dominant shareholder, in

this case a parent company, the corporation's residence for tax purposes was considered to be England, the place of residence of the parent company. Similar decisions were rendered in Crossley Carpets (Canada) Ltd. v. M.N.R.[65] and Zehnder & Company v. M.N.R.[66] Under the "control and management" test, if the central control and management is exercised in several places, then the corporation is a resident of the said places. Thus in De Beers Consolidated Mines Ltd. v. Howe,[67] it was held that a company could be a "resident" of two places if important operations and policy decisions of the company are directed from both places.

Regarding corporations incorporated in Canada, if the corporation was incorporated after April 26, 1965, it is considered a resident of Canada in accordance with Section 139 (4a) (a), ITA. In the case of a corporation incorporated in Canada before April 27, 1965, it is considered a resident of Canada if, at any time in the taxation year or at any time in any preceeding taxation year of the corporation ending after April 26, 1965, it was a resident of Canada pursuant to the "management and control" test or if the corporation actually carried on business in Canada.

b. Liability of Domestic Corporations[68]

FRANCE

In France, under Article 205, CGI, an income tax, at

the flat rate of 50%, is levied on the annual net taxable income of domestic corporations.

French domestic corporations are subject to tax on income from all sources, foreign and domestic, with the exception of income from business activity carried on abroad.[69]

In connection with business income, Article 209, CGI, states that the corporation income tax applies only to income from business activity carried on in France. Thus, in a Reponse Ministerielle (Ministerial Answer), R.M. 11,296, J.O. 19 September 1958, Deb. A.N., p. 2700, it was declared that profits earned by a French corporation from establishments or branches outside France are not subject to corporate income tax even though remitted to France and entered in the books of the French corporation.

With respect to the rules when a corporation is considered to be "doing business in France", those applicable to individuals, as earlier discussed, also apply to corporations.

UNITED STATES

In the United States, Section 11, IRC, provides for a normal tax rate of 25% on annual taxable income not in excess of $25,000, and a surtax of 22% on annual taxable income exceeding $25,000. Accordingly, the combined corporate tax on annual income over $25,000 is 47%.

A domestic corporation is subject to tax on its world-wide income.[70] The fact that it is not "carrying on business in the United States" is of no moment because a domestic corporation is liable on its local and foreign income. In this regard, the rule in U.S. is different from France.

PHILIPPINES

The rates for a domestic corporation in the Philippines are 22%, if its total annual net income does not exceed ₱100,000, and 30% upon the amount by which such total annual net income exceeds ₱100,000.

As in the United States, there is no need to ascertain if the domestic corporation is "doing business in the Philippines" because it is subject to tax on its income both from local and foreign sources.[71]

CANADA

The rates for domestic (resident) corporations in Canada are 18%, if the annual amount taxable does not exceed $35,000, and 47% on the amount by which such taxable amount exceeds $35,000. The Old Age Security Act imposes an additional corporate income tax of 3% on the annual amount taxable computed in accordance with Part I of the ITA. It should be noted that there is a proposal to change the tax rates for corporations pending before the Canadian Parliament.[72]

As in the United States and the Philippines, domestic (resident) corporations are, under Section 2, ITA, subject to tax on their income from both local and foreign sources.

As to whether or not a corporation is "doing business within Canada", this problem is already resolved by the determination whether a particular corporation is "resident" or "non-resident" in Canada.

In Canada, there can be no complete discussion of the tax treatment of corporate income without a consideration of the so-called "personal corporation".

A "personal corporation" is not considered as an entity separate and distinct from the individual shareholders for income tax purposes. Income is taxed in the hands of the individual shareholders in accordance with the formula laid down under Section 67 (3), ITA. It should be underscored that this matter is unique to Canada, and does not obtain in the United States, France, and the Philippines.

Section 68, ITA, defines a "personal corporation" as "a corporation that, during the whole of the taxation year in respect of which the expression is being applied, (a) was controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever, by an individual resident in Canada, by such an individual and one or more members of his family who were resident

in Canada by any other person on his or their behalf; (b) derived at least one quarter of its income from (i) ownership of or trading or dealing in bonds, shares, debentures, mortgages, hypothecs, bills,notes or other similar property or an interest therein, (ii) lending money with or without securities, (iii) rents, hire of chattels, charterparty fees or remunerations, annuities, royalties, interests or dividends, or (iv) estates or trusts; and (c) did not carry on an active financial, commercial or industrial business."

For purposes of Section 68, "members of his family" refers only to the spouse, sons and daughters, and does not include daughters-in-law and sons-in-law. Thus, if a father and a daughter jointly control a corporation, there is no doubt that the same is a personal corporation. However, if an individual and a sister own majority of the shares in a company, the said company is not a personal corporation.

An important problem involving "personal corporations" deals with the meaning of "control".

In Noble v. M.N.R. [1917], 12 T.C. 926, it was unequivocably declared that the phrase "controlling interest" referred to a person "whose shareholding in the company is such that he is more powerful than all the other shareholders put together in general meeting." In Wrights' Canadian Ropes Ltd. v. M.N.R., 2 DTC 927, it was also pointed out

that the fact that the Wrights owned only 49.86% of the shares was indubitable proof that they did not control the company.

There is authority for the proposition that a controlling interest includes both direct and indirect control. In No. 271 v. M.N.R., 55 DTC 514, the taxpayer was neither a registered shareholder or an employee of the company. He nominally transferred to another person the shares he owned. It was held that, since he in fact had control over the majority of the shares, he controlled the company.

It should be noted that control can also exist otherwise than through holding a majority of the shares of a company. Thus, where a company has no share capital, the controlling power can be identified by examining the Articles of Association. Moreover, control can also be exercised through an intermediate corporation. Hence, if a person is the majority shareholder of company X, and company X owns Company Y, the said person is considered to be in control of company Y.

In Settled Estates Ltd. v. M.N.R., [1960] S.C.R. 606 the appellant corporation was controlled by a person who designated his executors to hold his shares and control the company. On his death, the question arose whether a trust administered by "executors" could be considered as

an "individual" in accordance with the meaning attached to it under the ITA. It was held that, upon the death of the controlling shareholder, the status of personal corporation was lost. An "individual" must be "a natural living person resident in Canada capable of having a family". The Court pointed out that, under the Act, there were three methods of controlling, as follows: 1) by an individual resident in Canada, 2) by an individual and his family resident in Canada, and 3) by any other person on his or their behalf. The Court declared that the control of the executors did not fall within any of the said methods. The executors controlled the appellant company on behalf of numerous beneficiaries of the estate who did not qualify as "members of the family" and were not residents of Canada. However, the Court ventured the opinion that, if an executor held or exercised control on behalf of a person within the permitted class, it would be sufficient control within the meaning of Section 68.

Another important question relates to the meaning of "active" business.

Portigal v. M.N.R., 68 DTC 47, is a very significant case involving this particular point. Here, the appellant held one of the nine common shares issued in Clair's Holdings Ltd., a family company. The balance of the shares

were held by her husband and daughters. The Minister included in computing the appellant's income for 1963 the amount of $829 on the ground that the Clair's Holding Ltd. was a personal corporation and its income was taxable as deemed dividend in the hands of the shareholders in accordance with the provisions of Section 67(1). The appellant contended that Clair's Holdings Ltd. was not a personal corporation because it engaged in active financial business. It was established from the financial statements of Clair's Holdings Ltd. that, in the four years preceeding the taxation year under consideration, it was always considered by its accountants and shareholders as a personal corporation. Moreover, the entity's investments and operations in 1963 revealed that it was not engaged in an active financial business and was, therefore, a personal corporation in the year under review.

In Sawle Estate v. M.N.R., 67 DTC 524, four members of the family, including herein appellants, incorporated a private company in 1963. The purpose was to take over the ownership and management of certain real estates. The Minister treated the company as a personal corporation in 1964 and taxed each member shareholder with their respective share of its income as income appertaining to each of them under Section 67(1). The appellants argued that the company

was not a personal corporation because, in 1964, it was carrying on an active commercial business. It was held that the company was a personal corporation. The evidence showed that: the company's real estates consisted of four buildings from which the company derived rental income in the amount of $37,000 during the tax year 1964; the company also received a small investment income of around $1,000; it owned a lot which it leased to a car dealer; the company's administration and operation expenses were very low; its office was at the premises of an engineering office of one of the appellants situated 14 miles from where the company's real estate office was, and the rents were collected by the said member-shareholder; and, the janitorial expenses for the buildings amounted to only $25 a week. The Board considered the said facts as not sufficient to constitute an active commerical business.

c. Liability of Foreign Corporations[73]

FRANCE

Foreign corporations in France are subject to the same tax rates imposed on domestic corporations.

In so far as tax on business income is concerned, in France, there is no difference between the treatment of a French corporation and a foreign corporation. A foreign corporation is also subject to tax on income from local and foreign sources except income from business carried on

abroad.[74] In passing, it may be mentioned that the principle of equal treatment of French and foreign corporations is, by and large, limited to business income.[75] It does not apply to income derived from sources other than business. The rules applicable to individuals regarding "carrying on business" in France apply to foreign corporations.

UNITED STATES

In case of foreign corporations, in the United States, the question as to whether it is a resident or non-resident corporation must be resolved for purposes of determining its income tax liability. Foreign resident corporations are those engaged in business or trade in the United States and non-resident corporations are those which are not so engaged.[76]

In accordance with Section 881 (a), IRC, a foreign corporation not engaged in trade or business within the United States at any time during the taxable year is taxed only on fixed or determinable annual or periodicial income from United States sources. The tax rate on non-resident foreign corporations is 30% of their gross income.[77] It should be noted that, as to this type of corporation, the basis for taxation is the gross rather than the net income.

With respect to resident foreign corporations, the tax rates are similar to those of domestic corporations.[78] The said corporations are taxed only on their net income

from sources within the U.S.[79]

The rules regarding the determination whether or not an individual is "engaged in trade or business in the U.S." apply to foreign corporations.

PHILIPPINES

As in the United States, "residence" is necessary to determine the tax liability of foreign corporations. Resident foreign corporations are those engaged in trade or business in the Philippines.[80] Non-resident foreign corporations are those not engaged in trade or business in the Philippines.[81] The rules as to when an individual is considered as "carrying on business within the Philippines" apply to foreign corporations.

Resident corporations are subject to tax only on annual income derived from Philippine sources.[82] The tax rates imposed on domestic corporations are applicable to resident foreign corporations.[83] The basis of computing the tax payable with respect to foreign resident corporations is also the net income.

As in the United States, non-resident foreign corporations are treated differently. The siad corporations are subject to a flat rate of 35% on their annual gross income.[84]

CANADA

In Canada, foreign (non-resident) corporations are

only subject to tax on the annual taxable income derived from Canadian sources.[85]

Foreign (non-resident) corporations are subject to the tax imposed upon domestic (resident) corporations under Part I of the ITA.[86] They are also liable to pay income tax at a flat rate of 15%, under Section 106, ITA, as previously discussed in connection with the tax liability of non-resident individuals. In addition, the said corporations are subject to tax at the rate of 15% on the amount by which its taxable income earned in Canada, as determined under Part I, exceeds the aggregate of (i) its Part I tax for the year, (ii) provincial income taxes that are not deductible under Part I in computing its income from business carried on in Canada, and (iii) an allowance for the net increases in its capital investment on property in Canada.

The question whether or not a corporation is "doing business within Canada" is taken up in the determination of whether a particular corporation is a "resident" or "non-resident" in Canada.

3. Business Income and Unincorporated Entities as Taxpayers

FRANCE

In France, the phrase "unincorporated entities" is used as a generic term to refer to certain types of business organizations. The more important of the said entities are

the societe a responsabelite limitee (limited liability company), societe en nom collectif (general partnership), societe en commandite simple (limited partnership), societe en commandite par actions (limited partnership with shares), and association en participation (joint ventures).

A limited liability company resembles a corporation in structure.[87] It is subject to corporate income tax, at the rate of 50%, on all profits whether distributed or not.[88] Members of the company are not taxed on their aliquot shares of the firm's undistributed assets.[89] Any income distributed to members is taxed in the same manner as dividends paid by corporations.[90]

A general partnership, in France, is defined as "an association of persons carrying on an industrial or commercial activity under a common firm name, in such a manner that all of the partners are liable personally for the debts of the enterprise."[91] Membership in a general partnership is not limited to individuals. Corporations may become members of a general partnership.[92]

A general partnership is not subject to income tax as a separate and distinct entity. Every member of the partnership is subject to income tax on his share of the partnership profits, distributed or undistributed.[93] He may also deduct his share of partnership losses.[94] Civil partner-

ships will not be considered here because their income falls under the "non-commercial" category.[95]

Under Articles 206-3, 239-1, CGI, and Article 22, CGI Ann. IV, a general partnership may opt to be taxed as a corporation. The option has, however, been rarely exercised from the time the rate of tax on corporate income was increased to 50%.

The _societe en commandite simple_ corresponds to the limited partnership in the United States and the Philippines. It has two kinds of partners: the first is the general partner whose liability is unlimited and the second is the limited partner whose liability is limited to the amount contributed by him to the firm, and he cannot participate in the management of the business.[96]

The _societe en commandite par actions_ is quite similar to a limited partnership except that, here, the interests of the limited partners are represented by transferrable shares of stock.[97]

An _association en participation_ is a commercial organization where the members contribute assets for the purpose of carrying out a particular transaction or other objective and the sharing of profits and losses therefrom.[98] No notice of its formation need be made to the public.[99] In fact, the existence of the joint venture is, as a gen-

eral rule, not disclosed to third parties.[100] It is not considered as a legal entity separate and distinct from the participants, and third persons deal only with the individual participants in the venture.[101]

As to whether a limited liability company, general partnership, limited partnership, limited partnership with shares, or joint venture is a foreign or domestic entity, the rules governing corporations apply.[102]

In connection with the business income tax liability of a limited liability Company, a limited partnership with shares, and limited partners, the rules governing corporations are also applicable and binding.[103] If the partners in a general partnership or unlimited partners in a limited partnership opt to be taxed under the corporate rate, the rules on corporate income taxation will apply.[104] If they do not opt to be taxed under the corporate rate, the rules governing the tax liability of resident or non-resident individuals apply to them.[105]

In the case of an association en participation or joint venture, each participant is subject to tax on his aliquot share of the firm's earnings.[106] Nevertheless, profits from the joint venture, attributed to limited or undisclosed participants, are taxed in the hands of the firm as if the joint venture were a corporation.[107] The

joint venture may also opt to be taxed as a corporation.[108]

UNITED STATES

Under Section 761 (a) IRC, a "partnership" is defined to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business financial operation is carried on and which is not ... a corporation or a trust or an estate." The definition of a "partnership", in the United States, is very broad.

From the definition, it can be said that almost all types of unincorporated entities in France could be considered as partnerships, for tax purposes, in the United States.

The U.S. Tax Code draws no distinction between general and limited partnerships. Nevertheless, limited partnerships -- in which the financial liability of specified partners is limited to their investment in the business organization and in which management is lodged on the general partners alone -- are sometimes difficult to distinguish from corporations.[109] In some instances, said business organizations are deemed to be "associations" subject to corporate income tax. Thus, under Section 301, 7701-2 of the Regulations, if the organization is not interrupted by the death of a general partner or by a change in the ownership of his interest, if management of the business affairs

is centralized in one or more persons acting in a representative capacity, and if there is free transferability of interests and limited liability for the organization's debts, it may be classified as an "association" taxable as a corporation even though it is recognized as a limited partnership by state law.

Partnerships are not taxable entities and do not pay tax on their income as provided for under Section 701, IRC. The partnership is considered merely as a "conduit" through which income passes into the hands of the several partners. This is clearly pointed out in Section 702, IRC. A partner is taxed individually only on his share of annual partnership income, whether or not that income is actually distributed to him during the taxable year.

In connection with the ascertainment of the tax liability of partners, the rules regarding individuals, as discussed earlier, apply also to them. Thus, whether a partnership is domestic or foreign is not significant. The reason is that it is the status of the partners as individuals which determines whether they will be taxed as non-resident aliens and in what class of non-resident aliens they fall.

PHILIPPINES

Since the Philippines is basically a civil law country, the different types of unincorporated entities obtaining in

France can also be found in the Philippines.

Section 26, NIRC, provides that persons carrying on business in general co-partnerships (companias collectiva) duly registered in the mercantile registry, or those exercising a common profession in general partnership, shall be liable for income tax only in their individual capacity, and the share in the profits of the registered general co-partnership (compania collectiva) or in general professional partnership to which any taxable partner would be entitled, whether distributed or otherwise, shall be returned for taxation and the tax paid in accordance with the provisions on income tax. Thus, general partnerships are not taxable as separate entities.

With respect to "limited partnerships", since they fall within the term "partnerships" in the definition of "corporation," and only "general partnerships" are mentioned in Section 26, the said entities are subject to tax as corporations.

A civil partnership (sociedad collectiva) organized in accordance with the requirements of the Code of Commerce is considered as falling within the phrase "duly registered general co-partnership", and, as a consequence, is not a "separate taxpaying entity".[110] In France, where income is categorized into different types, a civil partnership is

not considered as earning business income. In the Philippines, since income is not categorized for purposes of taxation, civil partnerships are deemed to be earning business income.

Where the partnership is not registered, it is taxable as a corporation under Section 24, NIRC.

With respect to other unincorporated entities, as a general rule, they are taxed as corporations because of the very broad scope of the term "corporation" as defined under Section 84, NIRC. Thus, a "joint venture" is taxed as a corporation in the Philippines. It should be noted that a "joint venture" is considered as a partnership in the United States, and, hence, in said country, it is not considered as a separate taxpaying entity.

CANADA

In Canada, unincorporated entities are not as widely utilized by businessmen as they are in civil law jurisdictions like France and the Philippines.

The said entities, in Canada, are also not treated as separate taxpaying entities. Thus, under Section 6 (1)(c), ITA, it is provided that, in computing the income of a taxpayer for a taxation year, there shall be included his income from a partnership or syndicate for the year whether or not he has withdrawn it during the year.

Another provision governing unincorporated entities

is Section 16 (2), ITA. It states that: "For the purpose of Part I, a payment or transfer in a taxation year of property made to the taxpayer or some other person for the benefit of the taxpayer and other persons jointly in a taxation year shall be deemed to have been received by the taxpayer in the year to the extent of his interest therein notwithstanding that there was no distribution or division thereof in that year." This provision shows that other unincorporated entities, such as joint ventures or joint ownership of porperty, are also not treated as separate taxpaying entities in Canada.

C. GROSS BUSINESS INCOME

1. General Discussion

FRANCE

In France, in connection with the taxation of the income of individuals, there is a necessity to determine what business income is because of the schedular background of its income tax system. Thus, the French Tax Code specifies seven categories of income as follows: i) income from real property; ii) income from business; iii) income of executives of certain closely held firms; iv) income from farming; v) income from wages, salaries, pensions, and annuities; vi) income from non-commercial activities; and, vii) income from securities and similar income from

capital.[111]

For each of the seven categories, there is a definition of gross income.[112] Although a uniform rate is imposed on income of different categories, the taxable income is computed separately in accordance with specific rules.[113]

Article 34, CGI, defines business income as that derived from the carrying on of an industrial, commercial, or mining activity or from activity as artisan.

Industrial activity includes manufacture, transformation, and transportation.[114] In Article 35, CGI, commercial activity is described as covering the purchase of goods for resale; furnishing of lodging, food, or entertainment; rental of machinery and tangibles other than real property; and, financial activities such as banking and insurance. Mining activity involves the extraction of mineral resources. Income from artisan activity is defined as "income from the independent exercise of a trade or occupation that is essentially manual and requires only a limited amount of machinery and equipment."[115]

Income from the practice of the liberal profession, is not considered as business income in France.[116] Nevertheless, it is taxable as income from a "non-commercial" activity.

In accordance with Article 38-2, CGI, any sum, other

than capital contribution, that increases the net worth of a business enterprise, whether arising from an operation carried on voluntarily by the enterprise or from an exceptional occurrence, is taxable as business income. Thus, an extraordinary gain resulting from the requisition of an automobile of a business enterprise, even though it was compelled to dispose of the automobile with no voluntary act on its part, must be taken into account in computing business income.[117] The compensation paid by a landlord to a business tenant on eviction is also considered as taxable income.[118] The same could be said with respect to indemnity received by a firm from a competitor in return for an agreement to limit production to a predetermined quota.[119]

Grants and subsidies paid by the government to encourage the decentralization of industry or the purchase of new equipment are also considered as taxable business income.[120] Thus, it is not uncommon to hear complaints about the government taking with one hand what it gives with the other.[121]

Furthermore, the cancellation of a debt results in taxable business income. In R.M. 3,171, J.O. 3 May 1929, Deb. Ch., p. 1617, it was declared that gains arising from the repurchase by a corporation of its bonds are taxable as business income.

In another case,[122] the profit arising from the repurchase of an interest-free bearer note at a price lower than the amount of the liability of the enterprise, in accordance with its books, was held to be taxable income. However, the gains resulting from repurchase by a corporation of its own shares at a price less than par value are not considered as taxable income.[123] The reason is that the transaction is not considered as a cancellation of a debt.

The fact that an activity is illegal does not bar the taxation of the profits arising therefrom. In C.E. 10 January 1953, No. 16,084, the taxpayer was taxed for profits derived from illegal trade in liquor. In another case,[124] profits arising from illegal trade in gold and foreign exchange were also taxed.

In C.E. 1 July 1946, No. 79,603, it was held that a business enterprise is subject to income tax on the difference between the book value and the market value of what is given to it as a gift. Hence, in France, it is clear that gifts to business enterprises are subject to income tax.

Lastly, it should be pointed out that income from business includes income from accessory or secondary activities carried on by an interprise.[125] Examples of these

are: rent from building owned by the firm, royalties or dividends from patents or securities, and income from participants in joint ventures.

With respect to corporations and other entities subject to corporate income tax, it should be emphasized that income is not computed on a schedular basis. This is because the corporations and the entities are primarily organized for business purposes.[126] Thus, for corporate income taxation, the distinction between business income and those belonging to other categories is not legally meaningful.

UNITED STATES

The United States federal income tax is of a global-unitary character. The U.S. Internal Revenue Code does not classify income into various categories as is done in France. This is aptly explained as follows: "Thus, calculation and assessment of tax is based upon the totality of the taxpayer's income, as reduced to net, without regard to the source or derivation of the income. While this is the basic framework of the system, variations do exist under which the amount of income included or the rate of the tax itself will vary as to a particular item or class of income because of its source or character. However, the tax system is regarded as ... unitary ... in concept, so that variations are viewed as exceptions justified by the factors

present in the particular situation."[127]

On the basis of the above discussion, although under Section 61, IRC, "business income" is enumerated as included in the computation of gross income; under Section 62(a), IRC, there is also reference to "business" when it states that ordinary and necessary expenses are deductible if paid or incurred "in carrying on any trade or business"; and, as already discussed, the Internal Revenue Code provides that non-resident aliens and foreign corporations are subject to tax if "engaged in business in the United States", it is very difficult to find jurisprudential material regarding the meaning of "business income" as distinguished from other types of income in the United States. Nevertheless, there is no other meaning of "business" except the one mentioned in the discussions regarding the interpretation of "carrying on trade or business" and "engaged in trade or business within the United States." Accordingly, "business income", in the United States, is income from "business" pursuant to the meaning attributed to it when we discussed the tax liability of non-resident aliens and foreign corporations.

For purposes of this thesis, since income is not categorized in the United States, instead of discussing the concept of business income, as distinguished from non-

business receipts, the alternative is to delve into the distinction between income and non-income items.

Section 61, IRC, provides that a tax shall be imposed on "all income from whatever source derived". The phrase "all income" is very comprehensive and, it is clear, that the only limitation on its scope, aside from specific exclusions, under the IRC, is that which inheres in the concept of "income" itself.[128]

In Eisner v. Macomber,[129] "income" was defined as the "... gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets ..."

In accordance with the above definition, certain government subsidies were held not subject to income tax because the same did not qualify as "income" within the meaning of the Sixteenth Amendment to the U.S. Constitution.[130]

However, presently, in the United States, not all subsidies and grants emanating from the government are free from income tax. Subsidies which are in the nature of contributions to capital are not subject to income tax. Thus, in Brown Shoe Co. Inc. v. Commissioner, 339 U.S. 583 (1950), it was held that contributions, such as land, buildings, and cash, designed to induce a corporation to locate in a certain community were not subject to income

tax. On the other hand, subsidies which are for the purpose of defraying the operating expenses, supplement revenue, or compensate for the public use of, or for the recipients's forbearance to use, income producing property are subject to income tax as laid down in Detroit Edison C. v. Commissioner, 319 U.S. 98 (1943).

Hence, the rule, in the United States, with respect to subsidies is different from that in France. As discussed earlier, in France subsidies and grants are always subject to tax.

In Commissioner v. Glenshaw Glass Company,[131] the U.S. Supreme Court broadened the concept of "income" to include all receipts which constitute an accession to the taxpayer's wealth. Thus, in the said case, it was held that the receipt of punitive damages constitutes an undeniable addition to wealth, and, thus, the receipt should be deemed to be income falling under the broad statutory definition of gross income under Section 61.

As in France, under Section 1.6.-2 (d) (3) of the Regulations, gain arising from cancellation of indebtedness is income despite the fact that debtor at the time of cancellation receives no money or other saleable property.

Moreover, compensation received in non-cash form, such as shares of the employer's stock,[132] meals and

accommodations,[133] and the free use of an employer's property[134] are also considered as income for tax purposes.

As in France, the fact that a receipt is derived from an illegal business or transaction will not prevent its being taxed as income. Thus, amounts obtained by way of blackmail, extortion, embezzlement, or other criminal activity are taxable.[135]

Unlike France, in the United States, under Section 102, IRC, a gift of whatever nature is not included in computing income. The reason is the fact that there is a separate tax for gifts levied upon both the donor and the donee.

PHILIPPINES

The Philippine income tax system is also of a global-unitary character. Thus, as in the United States, for the meaning of "business income", there is a need to look at the interpretations of "carrying on trade or business" and "engaged in trade or business within the Philippines" in relation to the tax liability of "non-resident aliens" and foreign corporations". These matters were already considered earlier.

As in the United States, for purposes of this thesis, the alternative is to discuss the concept of income as compared to non-income receipts.

Since the NIRC is patterned after the U.S. Tax Code,

there is no difference between the idea of "income" in the Philippines and the United States. Thus, gambling income, income from smuggling, bribery income and all other income derived from illegal sources or activities are taxable. Rewards to informers, prizes in cash or in kind from certain competitions or lotteries are also included in computing gross income.[136]

With respect to grants and subsidies, it is possible that, as in the United States, the same would also be not subject to tax in the Philippines if the subsidies constitute capital contributions. There is no decided case in the Philippines regarding grants and subsidies.

As in the United States, in accordance with Section 29 (b) (3), NIRC, amounts received as gifts are not included in computing income.

CANADA

In Canada, as in France, the question as to whether or not income is derived from business is important because, under its tax system, income is also classified into several categories, as follows: i) business income; ii) income from property; and, iii) income from office and employment.[137]

The Canadian tax system is also similar to France in that, although the various categories of income are computed separately, there is a uniform tax rate for all categories.

However, unlike France, in Canada there is no conclusive presumption that the income earned by a corporation is "business income".

Section 4, ITA, declares that income from business is the profit from business. "Business" is defined in Section 139 (1), ITA. As previously discussed, it states that "business" includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade, but does not include an office or employment.

One of the leading authorities with respect to the meaning of "business income" is the English case of Graham v. Green.[138] In this case, the winnings of the apellant on horses constituted his sole source of income. The Crown contended that the winnings were taxable as profit from business. It was held that the proceeds of a bet did not constitute business profit. It was explained that a bet is merely an agreement that one person should pay another something on the happening of an event. There is no relevance between the happening of an event and the acquisition of property because the event does not "produce" the winnings. However, it was declared that a concern in the nature of trade or an adventure of trade could be organized in a manner whereby the winnings are not derived from

the activities of the organization.

In a Canadian case,[139] the taxpayer attended the races regularly. He owned an interest in at least three race-horses from which he made very little profit after taking care of the expenses. He bet heavily and continuously through the "pari-mutuel system". The taxpayer usually realized a gain. It was held that the taxpayer was carrying on business. The conclusion was based on the following facts: that he had an interest in several horses; that he attended the races systematically; that he bet heavily notwithstanding that he could not afford to lose; and, that he had the advantage of inside information from jockeys and other persons because of his ownership of race horses.

However, in M.N.R. v. Morden,[140] a habitual gambler who engaged in various kinds of gambling and did so for excitement was not held taxable on his gaming gains because his gambling could not be said to have been organized as a business. In another case,[141] it was pointed out that prize money won by a retail merchant in a solitary lottery and totally dependent on chance was not business income.

Thus, earnings arising from a solitary act of gambling or gambling for pleasure or gambling in an unorganized manner are not considered as business income. On the other hand, gains from gambling in a systemating or organized

manner is considered as income from business.

With respect to the taxability of income from illegal activity, there is no difference between Canada, France, the United States, and the Philippines.

In the No. 275 case,[142] a lady was assessed on her earnings as a prostitute. She contended that her income was not derived from business. On the alternative, she also claimed that, even if her earnings could be classified as business income, the State should not share on it because it resulted from something evil per se. It was held that the earnings were derived from business. Moreover, it was stated that, once the fact that the income arose from business is established, the taxing power is no longer required to look into the character of the business in question.

It should be emphasized that a taxpayer could split his businesses or have income from more than one business for purposes of taxation. This was the rule laid down in Burnaby Paperboard Ltd. v. M.N.R., 68 D.T.C. 12, a litigation involving the deductibility of a loss item. In this case, the appellant's operations were divided into an eastern and western division. The eastern division activities consisted mainly of the purchasing and vending of roofing products. The western division included a paper mill, a felt plant, a steam plant, the manufacture of

roofing materials and the merchandising of roofing and building materials. The appellant sold its roofing business, including the goodwill attaching thereto, and the right to use the brand name "Sidney Roofing Products". The physical assets used in the manufacture of roofing products included in the sale were roofing and saturator machines, a finished product warehouse, an asphalt packaging plant and flux tanks. The assets sold amounted to 25% of the physical assets of the complex. The accounts receivable relating to the roofing business were included in the sale except for those few which also bought paper products. After disposing of its roofing business, the appellant changed its name to Burnaby Paper Ltd. Since the receivables were sold for $40,000 less than the face value, the appellant claimed the said amount as a deduction after complying with the requirements of Section 85D, ITA. The Minister disallowed the deduction. It was held that the $40,000 was properly deductible. It was pointed out that substantially all of the tangible and intangible assets of the roofing business were sold. Moreover, the appellant renounced its former name and agreed that it would not compete in the roofing business in Canada for a specified period of time. In accordance with the rule that a taxpayer could have more than one business, the roofing business was considered as

different from the other activities of appellant's holding company. Thus, the sale of the same was adjudged as the sale of a business entirely separate from that of its mill.

Watts v. M.N.R.,[143] is a case involving the distinction between gift and business income. Here, the respondent received sums of $4,000 and $15,000 for participating in an architectural competition. The Minister assessed the amounts as income from business. The respondent contended that the same should be considred as gifts. It was held that the moneys were received as a result of a contractual relationship falling under the definition of "business" in accordance with Section 139 (1) (e).

In another case,[144] the appellant corporation applied for and was entitled to payment from a hurricane relief fund raised to provide assistance and relief for people in Ontario who suffered as a result of the storms and accompanying floods. The money was raised by donation. The measure of payment was in accordance with the value of proven losses. The appellant was paid $40,000 representing compensation for loss of crops and losses of containers and supplies. The Exchquer Court held that the compensation was not business income. It said:

> "The gift here in question, it seems to me, is of an entirely personal nature, wholly unrelated to the business activities of the appellant.

> The fact that the recipient is incorporated and that the gift was a large one does not affect the true nature of the payment, which, in my view, is precisely of the same kind as if the amount had been received by a neighbor of the appellant who had suffered flood damage but who was an individual and received less than did the appellant."

It appears that, in Canada, unlike the Philippines and the United States, as can be gleaned from the foregoing case, a gift relating to the business activities of the donee is subject to income tax.

The problem as to whether or not money received as government subsidy constitutes "business income" is interesting. As a general rule, the problem is resolved along considerations of drawing a distinction between business capital and income. Invariably, the decision is that money received as subsidy from the government is not taxable because it constitutes capital.[145] There is also the view that money given as subsidy is not taxable because the government should not tax what it gives.[146] Thus, the rule in Canada as to subsidies is the exact opposite of that in France.

Income derived from foreign exchange transactions have, on several occasions, been adjudged to be taxable.

In Imperial Tobacco Ltd. v. Kelly,[147] an English manufacturer bought some American Dollars for the purpose of purchasing raw materials in the United States. The manu-

facturer due to "impossibility" failed to purchase the necessary raw materials. In the meantime, the American Dollars increased in value. As a result, the manufacturer made some profits. It was held that the profits were taxable business income because the Dollars were purchased as a first step to an intended commercial transaction. Also, the fact that the intention to buy raw materials became impossible to perform did not mean that the Dollars lost the revenue character that attached to it when the same was originally bought.

In a Canadian case,[148] the appellant arranged for a line credit in Sterling through a London bank in order to pay its British suppliers. The Pound was later on devalued, and, because of this, the appellant made some profits. The profits were adjudged to be taxable business income. The reason was founded on the fact that the purchase of the dollars was a necessary part of the appellant"s trading operations. There was also evidence that the buying of the Sterling was for the purpose of speculating in currency.

Forgiveness of a debt is another complicated topic relating to business income. This was the subject of controversy in Oxford Motors Ltd. v. M.N.R.[149] Here, due to certain credit restrictions, the appellant, a car dealer, found it very difficult to dispose its inventory. The

car manufacturer agreed to give a rebate of $250 per car. Each time a car was sold the rebate was applied to the outstanding indebtedness of the appellant. The Minister claimed that the rebates constituted profits earned in the course of business. The appellant contended that it was merely a foregiveness of a debt. It was held that the profit realized was taxable business income. The fact that the rebates took the form of credits did not alter their true nature or make them the forgiveness of a debt incurred in a previous year. The rebates were so intimately related to the appellant's trading operations that the profit realized could only be a profit from business.

Compensation paid for the cancellation of a contract may or may not be considered taxable income. In Edgerton Fuels Ltd. v. M.N.R.,[150] where the contract was considered fundamental to the business of the appellant and constituted the whole structure of the appellant's profit making apparatus, the contract was adjudged to be a capital asset. Accordingly, the compensation paid for the cancellation of the contract was held to be a capital receipt not subject to tax.

Unlike France, in Canada profits from service businesses and the practice of the professions are unquestionably taxable as business income. However, where payments are

made for services rendered or to be rendered in a manner not within any reasonable conception of carrying on trade or business, there is some complication. The general rule is that the earnings are not considered as business income arising from services rendered. Nevertheless, if the gains arise from trading ventures or concerns, or profit making schemes, although the transactions relating to them may be isolated, the gains are usually considered as business income arising from services rendered. Thus, in Campbell v. M.N.R.,[151] a professional swimmer contracted with a Toronto newspaper to swim across Lake Ontario and to give it the exclusive rights to the story. She was supposed to get $5,000. She failed to swim across Lake Ontario. She was anyway, paid for her efforts. The payment was held to be professional income. The emphasis was on the fact that there was a practical business compulsion on the donor to make the payment.

2. Gross Income From Business Defined

FRANCE

In France, the gross benefices industriels et commerciaux (income from business) is defined as the receipts from all operations carried on by the enterprise including gains from the sale of capital assets.

Under Article 38-2, CGI, corporate gross income includes all receipts that flow into the enterprise during

the fiscal period, except apports (capital contributions).

Thus, regardless of whether the taxpayer is an individual or a corporation, gross business income is computed by adding all receipts from "business" within the context of our previous discussion.

Although capital contributions are never treated as income from business, capital gains are considered as forming a part of gross business income. Nevertheless, capital gains are taxed in accordance with specific rules.

As to individuals, they are, with certain exceptions, not subject to tax on capital gains arising from the sale of "non-business assets".

The exceptions relate to capital gains arising from the transfer on expropriation of unimproved land for building purposes, the lending of securities, the sale of buildings by contractors and the sale of real property held for less than five years.

Regarding the transfer or expropriation of unimproved land for building purposes, in accordance with Article 35, Law No. 63 - 1241 of December 19, 1963, the taxable capital gains consist of the difference between the price of the sale or expropriation indemnification and a sum equal to the price for which the property was bought by the taxpayer or by his forbears if the taxpayer acquired it by gratuitous

title. It should be noted that the acquisition price is increased by 25% to cover purchase and other related expenses. It is also increased by 3% for each year the seller has held the property. The amount of capital gain computed, in accordance with the above formula, is subject to tax rates for individuals only to the extent of 50% if the property was acquired by gift or inheritance. In any other case, the tax is imposed on 70% of the amount in question. The percentages of 50% and 70% were respectively reduced to: 30% and 50% for sales occurring in 1963 and 1964; 35% and 55% for sales in 1965; 40% and 60% for sales in 1966; and, 45% and 65% for sales in 1967. Moreover, under Article 35, capital gains are not subject to tax when the total amount for a taxable year does not exceed 50,000 Francs. For capital gains between 50,000 Francs and 100,000 Francs, the difference between 100,000 Francs and the capital gains is taxable. If thecapital gains exceed 100,000 Francs, the entire amount is taxable.

The above rules also apply to the taxation of capital gains arising from the conveyance of securities.

In France, non-resident individuals engaged in the real estate business are subject to both the tax on capital gains, under Article 35, to the extent of 50% of the gains and the income tax at the ordinary rates pursuant to the provisions

of Article 4, CGI. However, the tax paid under Article 35 may be claimed as a tax credit for purposes of paying the tax under Article 5, CGI.

Gains arising from the sale of a building by a contractor, under Article 28-IV, Law 63-254, March 15, 1963, are specifically made taxable as capital income at the rate of 15%. However, the gain must be earned by a contractor who is habitually engaged in the construction and sale of buildings. If the contractor is not habitually engaged in said transactions and the sale qualifies as a "purely occasional" transaction the gain would be exempt from tax. In Canada, the gain would be treated as a taxable ordinary gain if the contractor is habitually engaged in the construction and selling of buildings. If the gain is "purely occasional", it is not taxable because capital gains are not subject to tax in Canada. The Canadian rule is similar to those in the Philippines and the United States. The only difference is that capital gains are taxable in the latter countries.

The rules pertaining to the taxation of capital gains from the sale of real property held for less than five years are provided for under Law 63-1241, December 19, 1963 and Decree 64-80, January 29, 1964. The tax applies to sales of all real property, whether improved or unimproved,

and whether used for housing, indusrial, commercial, or other purposes. Nevertheless, the tax does not apply if the seller is able to show that he acquired the property without speculative intent. Pursuant to Article 153 of Circular 18 February 1963, it is conclusively presumed that the seller had no speculative intent if he is able to show that: a) in the period since he acquired the property, or since he constructed the building thereon, he personally or his spouse or an ascendant or descendant relative occupied the property as residence and b) that the sale had been motivated by a change of residence or family reasons (motivee par une meilleure utilisation familiale). The gains are taxed at the ordinary income tax rates for individuals.

With respect to the sale of business assets, there is no difference between the tax treatment of capital gains betweeen individuals and corporations pursuant to Act No. 65-566 of July 12, 1965 and the Administrative Instruction of March 18, 1966.

The capital gains tax on corporations depend upon whether the gain is long-term or short-term. Short-term capital gains arise if the asset trasnferred was acquired or created less than two years before the transfer. The capital gain is long-term if the asset was acquired or created two years

or more prior to the sale.

Short-term capital gains are taxable at the ordinary rates. However, payment of the same could be made over a period of five years. Long-term capital gains are taxable immediately but only at the reduced rate of 10%.

It is important to note that gains arising from the sale of capital assets, subject to depreciation, are always considered as short-term gains regardless of the holding period if the profits arise out of depreciation deductions.

Since capital gains are treated differently, it is important to know the distinction between "capital gains" and "ordinary business income".

Articles 35-1° to 6°, CGI, consider business income as the income of persons who habitually buy and sell in their own names (marchands de biens) real property; going concerns or interests in certain real property companies; those who act as brokers involving the above transactions; persons renting to otherscommercial or industrial establishments equipped for operation; as a general rule, those who subdivide lands; and, certain concessionaires and others engaged in special activities.

Hence, business income can only result from "habitual trading". If the income does not arise from "habitual trading", it is a capital gain.

In determining whether trading is "habitual", the number of transactions, the length of the various holding periods, the nature and quantity of the properties involved, and the magnitude of the operations are taken into account.[152]

A mere isolated act of trade, as a general rule, is not treated as constituting business activity. The activity producing the income, although not necessarily frequent, must be repeated. In C.E. 3 April 1937, No. 30,552, where a taxpayer within a year sold or exchanged seven automobiles bought by him and also sold some other items, it was held that, because of the repeated nature of the operations, his profits were taxable as business income. In C.E. 16 July 1947, No. 77,335, the profits of a salesman engaged in six commodity transactions over a period of three years were considered to be ordinary gains.

In another case,[153] the taxpayer transacted business through a specialist in the stock market who was given a full power of attorney. Twenty-four sales were made during a 12-month period. Out of the 24 sales, 12 involved shares held for less than one year. The taxpayer was held to be a habitual trader and, hence, his earnings were not considered as capital gains but ordinary income.

In still another case,[154] an individual who had made several hundred transactions yearly during a period of four

years, involving a total of 130,000 shares in 80 different companies, was also held to be a habitual trader.

There is, however, an exception to the rule that "business activity" can only arise out of repeated transactions.

C.E. 13 July 1954, No. 19,560, is illustrative. In this case, an individual inherited certain stocks of goods and disposed of it over a number of years. His gains were considered as taxable business income on the ground that an isolated act will result in business income if its execution is performed over a long period of time. Hence, despite the absence of the element of "repeated transactions", if the execution of the "isolated transaction" is done over a long period of time, the income arising therefrom will be considered as business income.

Due to the conclusive presumption that corporations are organized for the purpose of engaging in business, gains arising from isolated transactions of corporations are taxed as ordinary gains.[155]

The nature and the quantity of the properties bought also determine whether or not a person is a habitual trader. The earnings of a person who buys numerous real properties or the goodwill of business enterprises upon the sale of the same are definitely ordinary rather than capital gains.[156]

In the above example, because of the nature and quantity of the properties purchased, the presence of "speculative intent" cannot be denied. In like manner, the income of individuals engaged in subdividing land for resale is clearly an ordinary gain.[157]

As previously stated, capital gains arising from the sale of "non-business" assets by individuals are, subject to certain exceptions, exempt from tax. The French Tax Code does not give any definition of a "non-business" asset. However, from the decided cases, it can be implied that a "non-business" asset is one which is not utilized by an individual in his trade or business.

Thus, gains realized by an individual inventor on the outright sale of all his rights in a patent are not subject to income taxation. In R.M. 7,068, J.O. 11 September 1948, Deb. A.N., p. 6498, it was declared that the immunity from taxation extends to the situation where the inventor sells his rights in the patent for periodic payments, including royalties geared to the amount of sales. Article 1, Circular 2,248, 31 July 1948, declares that the immunity extends to the case in which the inventor exchanges his patent for shares in the corporation that will exploit the patent. In R.M. 12,797, J.O. 9 June 1962, Deb. A.N., p. 1630, it was stated that if royalty payments are free of tax in the

hands of the inventor as price of all his rights in a patent, payments remain free of tax in the hands of the heirs.

It should be emphasized that, under Article 92-2, CGI, the rule exempting from tax gains on outright sale of the inventor's patent does not apply to gains on the sale of trademarks, secret processes, or formulas. Moreover, in accordance with the said provision, authors, composers, or their heirs do not receive special treament. Hence, gains on the outright sale of a copyright is taxed in the same manner as royalties are taxed. Royalties are taxed as "non-commercial" income in France.[158]

Another important rule, regarding the sale of patents, is that the doctrine of "habitual trading" is not applicable to the individual inventor. The rule that exonerates from tax the proceeds of the sale of a patent by an individual inventor applies regardless of the number of patents the inventor sells or the frequency he engages in said transactions.[159]

Let us summarize the concept of capital gains with respect to individuals by way of example. Let us assume that a person engaged in the business of selling cars owns a television and a building used as the office of his car selling business. If he sells the television, he is deemed to have sold a non-business capital asset. Hence, he is not subject

to tax on his profits. If he sells the building used as office for his business, he is considered to have disposed a business asset, and is, thus, subject to capital gains tax. The earnings are not treated as ordinary gains because the selling of buildings is not his business. If he is able to sell cars, then his gains are subject to tax as ordinary business income.

It is respectfully submitted that the exemption from capital gains tax as to profits arising from the sale of "non-business" assets does not apply to corporations. The reason for this is the presumption that a corporation is organized for the purpose of doing business. Thus, all its assets are business assets, whether they be capital in nature or inventory.

The taxation of capital gains in France is very complicated. It violates the fundamental principle that a statute should be clear and simple in order to avoid confusion and unnecessary litigation. It is respectfully submitted that the problems regarding the tax treatment of capital gains can considerably be eliminated if France abandons its hesitant attitude to tax capital gains all the way in accordance with the system in the United States. There is no way of reconciling American and civil law tax concepts. The Philippine experience has shown that any attempt to integ-

rate civil law with American common law concepts can only result in confusion. Since France already adopted certain aspects of the American system of taxing capital gains, it is left with no alternative but to adopt the rest or to return to the purely French treatment of capital gains.

UNITED STATES

Again, due to the global-unitary character of the U.S. tax system, there is no definition of gross business income in the Internal Revenue Code. However, in accordance with Section 1.61-3 of the Regulations, the "gross income" of a business enterprise normally means its "total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources".

As a general rule, the cost of raw materials, direct labor costs, and other direct charges are included in the term "cost of goods sold".[160] If inventories are considered as an income-producing factor, then the costs of goods sold represent "inventory at the beginning of the taxable year, plus inventory purchases, direct labor costs, supplies, and other direct charges, less inventory at the close of the taxable year.[161]

As in France, capital gains are included in computing gross income and there are special rules governing the taxability of the same.[162]

The taxation of capital gains, in the United States, depends upon whether the gain is short-term or long-term. If the holding period with respect to a capital asset is more than six months, the gain arising from the sale of the same is considered long-term. If the holding period is for a shorter time, the gain is short-term.

With respect to individuals, there are two alternative preferential treatments regarding the taxation of long-term capital gains, as follows: the gains are taxable at the ordinary rates to the extent of 50% or the gains are taxable in full at the rate of 25%. As to corporations, capital gains are taxed only at the rate of 25%.

There is no preferential treatment accorded with respect to the taxation of short-term capital gains.

It should be noted that, in the United States, non-resident aliens are not subject to capital gains tax.

Unlike France, in the United States, there is no rule that individuals are not subject to tax on the sale of non-business assets. However, it is important to understand the concept of capital gains because of the preferential treatment given to the same.

In the United States, unlike Canada and France, the question as to what constitutes a capital gain is determined without a consideration of the concept of business

income. This approach considerably simplifies the whole problem.

There are two factors involved in the classification of gain as capital or ordinary. One factor relates to the nature of the asset involved: for capital treatment to exist, the asset must be a "capital asset". The second factor relates to the nature of the transaction giving rise to the gain. Under the Internal Revenue Code, the transaction should be an "exchange or sale". If the profit arises from "sale or exchange" of a "capital asset", it is considered as a capital gain.

Section 1221, IRC, defines a "capital asset" as property held by the taxpayer, except the following: i) inventory, stock in trade, property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, and accounts or notes receivable acquired in the ordinary course of trade or business; ii) real and depreciable property used in the taxpayer's trade or business; iii) copyrights, literary, musical, or artistic compositions and similar properties, if the taxpayer created such property by his personal efforts or acquired the property from its creator by gift or in a tax-free exchange; and, iv) certain short-term governmental discount. Thus, anything not falling under the exceptions

enumerated above is considered as a "capital asset".

"Sale or exchange" is not defined in the U.S. Tax Code. To ascertain its meaning, it is, therefore, necessary to resort to case law and certain statutory provisions.

Section 1232, IRC, provides that the retirement of certain corporate and governmental bonds, debentures, and other certificates of indebtedness shall be treated as a "sale or exchange". However, in judicial decisions, the collection of a debt or the settlement of a claim is not considered as a sale or exchange.[163] Thus, the transactions enumerated under Section 1232 should be considered as exceptions to the general rule that the collection of debts or the settlement of claims do not fall within the meaning of "sale or exchange". Accordingly, amounts collected for debts or by reason of the settlement of claims are not considered as capital gains.

Furthermore, Section 1241, IRC, provides that the "sale or exchange" requirement is satisfied when a lessee obtains payment for the cancellation of a lease, or a distributor of goods who has a substantial capital investment in the distributorship receives payment for cancellation of the distributorship agreement. In the situations mentioned, the payments are considered as capital gains. As previously discussed, in Canada, the said payments are

also considered as capital gains.

In Commissioner v. Green, 126 F 2d 70, (3rd Cir. 1942), it was held that the transfer of property pursuant to a foreclosure is a "sale or exchange". However, in Polin v. Commissioner,[164] it was held that a compromise payment on a note does not constitute a "sale or exchange" where the mortgagor is actually not personally liable, and, hence, the creditor does not have a capital gain if the payment exceeds the face value of the note.

The transfer of a capital asset in satisfaction of a valid claim against the taxpayer is considered a "sale or exchange". If the property which is the subject of the claim appreciates in value, the increment is considered as capital gains.[165] Thus, the transfer of a capital asset to satisfy the claim for support of a former spouse was considered as falling within the term "sale or exchange".[166] The claim of a beneficiary from an estate involving a money legacy was also considered as "sale or exchange".[167]

The relinquishment of certain rights to income is considered as satisfying the requirement of "sale or exchange". Hence, in McAllister v. Commissioner,[168] the relinquishment of an estate for life for consideration was adjudged as a "sale or exchange". On the other hand, the reliquishment of other interests is deemed merely a surrender of rights pro-

ducing ordinary income. Consequently, the relinquishment of an employee's interest in an employment contract was not treated as a "sale or exchange".[169]

The disposition of non-mineral rights on a royalty basis, such as patents or literary creations, by the owner is considered as a "sale or exchange".[170] However, the disposition of a mineral interest on a royalty basis is not treated as a "sale or exchange".[171]

Lastly, the transfer of less than all the substantial rights in a patent is not treated as a "sale or exchange" in accordance with Section 1235, IRC. However, under Herwig v. United States,[172] the transfer of a divisible interest in other types of assets, such as the right to exploit a copyrighted work in television, is treated as a "sale or exchange".

Viewed in the light of the foregoing, it is very difficult to come up with a general definition of "sale or exchange". The question whether or not a transaction is a "sale or exchange" must be resolved in accordance with the existing facts and the nature of the transaction.

PHILIPPINES

As in the United States, because of the global-unitary character of the Philippine tax system, the NIRC does not contain a definition of "gross business income." Section

43 of the Regulations simply defines it in almost similar terms as its U.S. counterpart. However, there is no doubt that "gross business income" is the income of persons or entities "engaged in trade or business" as earlier discussed.

As in France and the United States, capital gains are also included in computing gross income and there are special rules pertaining to it.

The taxation of capital gains in the Philippines also depends upon the holding period. In accordance with Section 34, NIRC, if the capital asset sold or exchanged was held by a taxpayer, other than a corporation, for not more than twelve months, the gain is taxable in full at the ordinary income tax rates, However, if the property was held for more than twelve months, the gain is taxable at the ordinary rates only to the extent of 50%.

Corporations are not granted any preferential treatment in connection with the taxation of capital gains.

In the Philippines, as in the United States, individuals are subject to capital gains tax on the sale of non-business capital assets.

Since capital gains enjoy preferential treatment as compared to ordinary business gains, it is also important, to know the distinction between capital gains and ordinary gains.

In the Philippines, as in the United States, the meaning of capital gain is considered independently of the concept of business income. Likewise, there are two factors affecting the determination whether or not a gain is of a capital variety. The transaction must be a i) "sale or exchange", and ii) it must involve a capital asset in order that the gain arising therefrom may be classified as capital gain.

With respect to the rules as to what constitutes "sale or exchange", there is no difference between those obtaining in the United States and in the Philippines. In fact, Revenue officials rely heavily on American rulings and jurisprudence on the matter.

The NIRC states that the term "capital assets" means "property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation ...; or real property used in the trade or business of the taxpayer".[173]

Unlike the United States, in the Philippines, under Section 22 (b), NIRC, non-resident aliens are subject to capital gains tax in accordance with the ordinary income tax rates imposed upon individuals.

CANADA

In Canada, in accordance with Sections 3, 4, and 139 (1) (e), IRC, the "gross business income" of a taxpayer refers to income for a taxation year derived from a calling, trade, manufacture or undertaking whatsoever and includes an adventure of trade or concern in the nature of trade but does not include an office or employment.

Capital gains are not subject to income tax in Canada. Thus, it is important to know the distinction between capital gains and income from business.

As in France, in Canada, the concept of "capital gains" is considered in relation with the concept of business income. However, in France, the approach is simpler because the only question considered is whether or not the taxpayer is a "habitual trader". It is respectfully submitted that it is more difficult to ascertain what constitutes a "capital gain" in Canada because of the existence of so-called concept of "adventure or concern in the nature of trade". The said concept does not exist in the United States, France, and the Philippines. As already stated earlier, in the Philippines

and the United States, the concept of "capital gains" is considered apart from the concept of business income.

There are several indicators in determining whether a gain is business income or of the capital variety, as follows: 1) the number and frequency of transactions; 2) the nature of isolated transactions; 3) adventure in the nature of trade; 4) the intention of the taxpayer; 5) related business activities; 6) subject-matter of the transaction; 7) objects of a corporation; 8) organized efforts; 9) fixed or circulating assets; and, 10) other miscellaneous factors. Regarding "other miscellaneous factors", certain portions of it were already discussed earlier and will not be covered here.

It should be understood that no single indicator mentioned above is sufficient to conclusively establish that a particular gain is either business income or of a capital nature. All the various indicators present in each case should be weighed. And only on the said basis can a decision be made.

The first indicator deals with the number and the frequency of transactions. It is settled that, as a general rule, the more frequent a person engages in a specific transaction, the easier it is to conclude that he is in business, and, hence, earning business income.[174] It is

a lot easier to say that a person is carrying on business if he buys and sells twenty cars in a taxation year than if he buys and sells only one car within the same period.

However, the fact that a transaction is an isolated one does not conclusively imply that the gain arising therefrom is a capital gain. Thus, in every case, there is a need to examine the nature of an isolated transaction.

If there is a manifest intention to make a profit out of the solitary transaction, the gain would be taxable business income. This was the decision in California Copper Syndicate Ltd. v. Harris.[175] In this case, the California Copper Syndicate Ltd. acquired a mine in the United States and then sold it for shares in the Fresno Corporation. It was proven that the Syndicate never intended to work the mine. It was held that the acquisition and the sale of the same was an endeavour to make profit by trade or investment despite the fact that the transaction was an isolated one. On the basis of the said case, it can, therefore, be stated that a person, who buys a capital asset without any intention of utilizing it for business purposes, earns income subject to tax when the asset is sold at a profit.

Another factor indicating a purpose to make a profit is the renovation or transformation of the thing purchased

to enhance its saleability. In a case,[176] the respondents bought an old steamer and renovated it. It was held that the profit arising from the sale of the steamer was taxable. The profits arose not from the mere appreciation of capital but from the expenditure of money for the purpose of making a profit in a venture in the nature of trade.

However, the fact that the thing purchased is not renovated does not mean that the gain arising therefrom would necessarily be a capital gain. In Edwards v. Bairstow,[177] the respondents purchased a spinning mill. They simply dismantled the whole thing and sold the parts piecemeal. It was held that the profits were subject to tax. The reason for the decision was the fact that there were circumstances showing a purpose to make a profit. Firstly, there was an organized effort because the sale was extensively promoted; rental was on a month to month basis for the storage of the parts; bookkeepers were hired; and, commissions were paid. Secondly, the respondents did not have any knowledge regarding the functioning of the machine. Hence, the possibility that they bought it for the purpose of resale rather than to use it was greater. Therefore, it is clear that gains arising from an isolated transaction are taxable as business income if other indicators such as, venture in the nature of trade, organized

effort, or intention to make a profit, are present.

Regarding the intention of a taxpayer as an indicator, the leading case is No. 341 v. M.N.R.[178] In this case, it was pointed out that intention is one of the factors entering into a determination of whether income is taxable or a capital gain. However, intention alone is not sufficient to establish that a profit is subject to tax. The whole conduct of the taxpayer must be considered. The principle is that, where transactions are really for the purpose of investment, casual profits arising therefrom are not taxable.

It should be noted that, in the above case, in the process of ascertaining the intention of the taxpayer, it was mentioned that the father of the taxpayer was engaged in the real estate business. The Court ruled that there could be no taxation by association. The fact that the father was in the real estate business did not necessarily imply that the taxpayer was also in the same line of business. There is, however, an exception to this rule. In M.N.R. v. Lane,[1964] C.T.C. 81, it was held that, with respect to a syndicate having passive members and an active member, the expertise of the active member in a particular line of business will be imputed upon the passive members in ascertaining whether or not there is an intention to speculate and earn taxable business income.

Regal Heights Ltd. v. M.N.R.,[179] speaks of a primary and a secondary intention. Both the primary and secondary intention must exist at the time of the purchase of the thing resold. In this case, a group of persons formed a partnership to purchase certain lands for the purpose of building a shopping centre in Calgary to obtain rental income. However, because the partnership was not able to sign a lease contract with a prospective client, it abandoned its primary objective and sold the land at a profit. The profit was held to be taxable income because a secondary intention to sell was established. In Aldershot Shopping Plaza Ltd. v. M.N.R.,[180] the facts were almost similar to those in the Regal Heights case. However, it was held that the profits arising from the resale were non-taxable capital gains. The reason was that the land was bought for the sole purpose of constructing a shopping centre. The land was acquired under the condition that a shopping centre would be erected on it and the construction would start on a specified date. In the Regal Heights case, no condition whatsoever was attached to the acquisition of the land.

In Elgin Copper Realties Ltd. v. M.N.R.,[181] the profits arising from the sale were also considered as capital gains because the sole intention of the taxpayer was to construct

an apartment building for investment purposes. The fact that the owner sold it after concluding that the methods utilized in constructing it were unsound did not convert the profits arising from the sale to taxable business income. Rithet Consolidated Ltd. v. M.N.R.,[182] was decided in accordance with the principle enunciated above. Here, a company was incorporated to administer the assets of an estate in accordance with the provisions of a will. One of the transactions of the company pertained to the sale of a non-revenue producing farm which the deceased operated as a hobby. The Exchequer Court held that the profits arising from the sale were non-taxable capital gains.

Assuming the existence of both a primary and secondary intention, it should be emphasized that the rule regarding secondary intention laid down in the Regal Heights case is subject to certain limitations. Despite the presence of a secondary intention, the gain is still income of a capital variety if 1) there is no commercial animus; 2) the intention to resell was not the activating or operative motivation; 3) the exclusive purpose is not to resell; or 4) the only reason for the sale is the increase in price of the subject-matter of the transaction.

The "commercial animus" limitation was laid down in Sterling Paper Mills Inc. v. M.N.R.[183] Here, the profits

from the sale of unwanted timber cutting rights were held to be capital gains. It was established that the appellant acquired the rights as part of the assets of another company and that it had to purchase the said rights in order to obtain a desired paper mill. Thus, there was no "commercial animus" in the purchase of the timber cutting rights. Consequently, the gains on resale were not subject to tax despite the presence of a secondary intention to resell.

The "activating or operative motivation" limitation was enunciated in Halzeadean Farm Co. Ltd. v. M.N.R., [1966] C.T.C. 107. In this case, it was held that the mere intention to resell is not sufficient to establish that the gain arising from the sale is taxable business income. The expectation to turn over must be the activating or operative motivation.

Barnett v. M.N.R., 70 D.T.C. 6713, considered the "exclusive purpose" limitation. It means that the subject-matter of the transaction was not bought with the intention of resale for profit and that it was purchased for some exclusive purpose, such as the construction of apartment houses.

The "mere increase in price" or "remoteness" limitation was explained in Shucketh v. M.N.R., 70 D.T.C. 6213. In other words, the mere fact that a person is induced to

resell a capital asset purchased with the aim of using it does not mean that the profit from the sale would be taxable business income. Thus, there must be a balancing of the priorities attached to the primary intention, on one hand, and the secondary intention to resell, on the other. If the priority given to the primary intention is very much higher in degree, as compared to the secondary intention to resell, it is easier to conclude that the profits arising are capital gains. However, if the priority attached to the primary intention and the secondary intention to resell are almost equal or equal, to say the least, the profits will be considered as taxable business income.

From the foregoing, it is clear that the Canadian courts are getting to be more liberal. It is definitely less difficult now to get a "capital gains decision" from courts. Other cases illustrating this liberal attitude of the courts are Cohen v. M.N.R.,[184] D.M. Westmorland et al v. M.N.R.,[185] and M.N.R. v. Industrial Glass Co. Ltd.[186]

Another notable indicator deals with the "related business activities" of the taxpayer.

This indicator simply points out that, if the nature of a transaction is such that it is so closely related or associated with the taxpayer's business activities, the

profits derived from the transaction will, most likely, be taxed as business income. Thus, if a taxpayer normally buys land on which he builds houses and sells the same at a profit, the act of purchasing a land is a related business activity. If, after buying a land, instead of constructing a house thereon, he sells it, the profits arising from the sale will be considered as taxable business income even if the land was allegedly bought for investment purposes and to assist a friend in England whose lands were subject to tax sale.[187] The non-existence of an intention to sell or re-sell at a profit will not exempt the taxpayer from income tax liability on the proceeds of the sale or resale, if the facts of the transaction otherwise indicate the carrying on of a business, as determined by an investigation of the taxpayer's similar or related transactions or activities.[188]

However, the fact that a transaction is related to the business activity of the taxpayer does not conclusively imply that the profits derived from the same will always be taxable business income.

In No. 13 v. M.N.R.,[189] the appellant constructed houses which he sold with the object of making a profit within the shortest possible time. In 1937, he constructed a double duplex with the intention of keeping it as an investment. In 1947, he sold the double duplex because of

certain changes in the vicinity detrimental to his renting business. The Minister contended that he should be taxed on the profit because his business was building and selling houses. It was held that the profit arose from the sale of an investment and, hence, was a capital gain not subject to tax.

In Gairdner Securities Ltd. v. M.N.R.,[190] Gairdner was the principal shareholder of the appellant company. The appellant company sold its business in 1938 but remained in the same trade in order to discharge its business obligations. In 1944, the appellant company obtained control over a malting company purportedly to provide management experience for Gairdner's sons. In 1946, the appellant company sold all its holdings in the malting company and made a profit. The issue was whether or not the control of the malting company was obtained as an investment. It was held that the appellant company had remained sufficiently in business to the extent that it could be considered as "in the business of dealing in securities" when it sold the shares in the malting company. The purchase and sale of the shares was closely allied with the appellant's ordinary business.

Hence, with respect to "related business activity", if the taxpayer is able to establish to the satisfaction

of the court that, although the purchase of a particular thing is related to his business activity, the same was bought for investment purposes, the profits derived from the transaction will be considered as non-taxable capital gains. If the taxpayer fails to meet the onus of proof required, his profits will be considered as taxable business income. Considering the above rules, it is thus possible for a taxpayer to be subject to tax on an isolated transaction related to his business activity and to be free from tax on another isolated transaction also associated with his business activity depending upon the manner he is able to meet the onus of proof required.[191]

The subject-matter of a transaction is another indicator in determining whether a gain is business income or of the capital category.

If the commodity purchased in a single transaction is not of a kind normally used for investment but for trading and if the commodity would not produce an annual return by retention in the hands of the purchaser, to conclude that the transaction is a trading one would be easy. However, if the subject-matter of a transaction is normally used for investment, such as land, houses, stocks and shares, the inference is not readily drawn.[192]

If a person buys the government surplus stock of

aircraft linen[193] or an unusually large quantity of lead[194] or thousands of tons of toilet paper,[194A] it is exceedingly difficult not to find an intention to resell the same. In the first place, it is beyond dispute that the above commodities, by themselves, would not be producing any profit. Moreover, the only way to earn income out of purchasing the said commodities is by selling them. In the absence of other facts, there is no way of explaining that the purchases were made for the purpose of investment. Profits from the same will, therefore, be subject to tax as trading income.

It should be noted, however, that simply because the commodity acquired is income-producing does not conclusively establish an investment if other facts clearly show that the intention was to earn a profit.[195]

Another indicator deals with organized efforts -- "badges of trade".

If the primordial objective of a venture is the pursuit of profits and organized efforts are exerted towards the attainment of the said objective, the profits arising therefrom will be considered as taxable business income. Hence, if an isolated transaction is a part of a promotional scheme and the taxpayer did not just sit down and allow the assets to appreciate by themselves, the profits derived from the

transaction will be subject to tax.[196]

Regarding "adventure in the nature of trade" as an indicator, the following are the important rules: i) an isolated transaction does not necessarily preclude an adventure in the nature of trade; ii) in every case, the character and surrounding circumstances of the transaction must be considered; iii) the fact that the transaction is totally different in nature from other activities of the taxpayer does not necessarily take a transaction out of the category of an adventure in the nature of trade; iv) the intention to resell may be an important factor but is not an essential prerequisite to the ascertainment of an adventure and its absence does not negate the idea; v) it is not essential that an organization be set up to carry the transaction into effect in order to find an adventure in the nature of trade; vi) if a person deals with the property purchased in the same way that a regular trader regarding property of the same kind would ordinarily do, the venture is an adventure in the nature of trade; and, vii) the nature and quantity of the subject matter of a transaction may be such as to exclude the possibility that the sale of the same is/the realization of an investment or that it could have been disposed otherwise as a trading transaction.[197]

Applying the above rules, it was held that simply

because a taxpayer deals extensively in farm lands does not mean that the profits from the buying and selling of a farm land are taxable as having been derived from an adventure in the nature of trade.[198] In this case, the surrounding circumstances indicated that the farm in question was bought as a capital asset needed in the business. Where the taxpayer bought numerous small mortgages with terms ranging from five to eight years at a discount, the payments made on the same were held taxable as profits arising from a venture in the nature of trade due to the sheer volume of the operation.[199]

Valclair Investments Co. Ltd. v. M.N.R.[200] is a case which underscores the fact that, at times, tax rules distinguish between the poor and the rich. In this case, the respondent investment company bought a farm near Montreal at $135,000 and rented it to a farmer for almost nothing. Two years later, it accepted an unsolicited offer to purchase the farm and made a huge profit. The profit was held not taxable. The purchase of the farm was considered as an investment because it yielded an annual return. The court explained that, although the return was negligible, it was not important because the return could vary depending upon the circumstances obtaining in each litigation. In this case, the amount of the annual return was not considered

important because the respondent had plenty of money. Moreover, the transaction could not be deemed an adventure in the nature of trade because the respondent did not possess any commercial animus and did not deal with the land as other traders in the same line of business would do.

In M.N.R. v. Industrial Glass Co. Ltd.,[201] due to zoning restrictions and pressure from the municipality, the respondent was compelled to sell a portion of the land which was being leased on a profitable basis. The respondent made a large profit out of the transaction. The profit was held to be a capital gain because the surrounding circumstances indicated the realization of an investment. This case should be distinguished from the Regal Heights case in that, here, only a portion of the property was sold. Hence, the original intention to invest did not disappear.

The "objects of a corporation" is not a very significant indicator in connection with the determination of whether a gain is business income or of a capital variety. The reason is that courts have realized that, lately, the objects contained in the memorandum of incorporation of corporate entities are so broad that it could engage in almost any kind of business.

In determining the tax effects of the "objects" of a corporation, the question is not what business or trade

the corporation could carry on under the memorandum of incorporation but rather what in truth was the business it did engage in.[202]

The objects appearing in the memorandum of incorporation cannot, however, be totally ignored. The correct rule is that the objects of a corporation in accordance with its memorandum is a factor to be considered in deciding whether a gain is of a capital variety or taxable business income. Nevertheless, it should not be taken as conclusive. Thus, in Glengate Investments Ltd. v. M.N.R.,[203] three business associates obtained some mortgages on two vacant lots from the division of the assets of a private company which was dissolved. A new company was incorporated with wide powers. However, the primary purpose was the realization of the assets mentioned. It was held that the sale was a realization of a capital asset as could be seen from the memorandum of the company and the fact that it is possible for a quasi-principal-agent relationship to exist between a corporation and its controlling shareholders.

In Western Leaseholds Ltd. v. M.N.R.,[204] a company organized for the purpose of drilling and marketing oil leased mineral rights and granted options to purchase mineral rights. The company made some profits from the said dealings. The profits were held taxable as ordinary income

because, although the company's ultimate object might have been to explore and develop its oil properties, the disposal of mineral rights was a line of business which the company, due to the lack of adequate capital, was prepared to undertake. Moreover, the company had the power, under its charter, to engage in the said undertaking.

Even if the object of a corporation is limited only to a specified undertaking such as, the operation of a clothing business, the said object shall only be considered as corroborative evidence in ascertaining the actual business of the corporate taxpayer.[205]

It should be noted that in Canada there is a decision stating that corporations are organized for the purpose of making profit.[206] Under this view, the burden of showing that the income of a corporation is a non-taxable capital gain is very heavy. This is not quite similar to the rule in France. In the latter country, the income of corporations are conclusively presumed as arising from business.

The fact that an asset is either fixed or circulating is also a notable indicator.

An asset is said to be fixed if it is being utilized in the business of the taxpayer or was purchased for the said purpose. A circulating asset is one which forms part of the inventory of the business. If an asset is classified

as fixed, the profits arising from the same will, as a general rule, be considered as capital gains. On the other hand, if the asset is of a circulating nature or, because of a change in the business of the taxpayer, a fixed asset is converted into a circulating asset, the profits from the sale of the same are taxable as business income.[207]

There are other miscellaneous factors which are also recognized as indicators in determining the nature of a profit.

Corporate shares are by nature different from other forms of property. They are not articles of commerce. The purchase of shares is, in itself, an investment being a potential source of revenue.[207A]

In Foreign Power Securities v. M.N.R.,[208] the appellant was an investment company. Its profits were not, normally, taxable. A second company bought the controlling share in the appellant company and then sold to it, at cost, shares of the Trans-Canada Pipe Line Co. and the Quebec Natural Gas Co. The Minister claimed that the entire transaction was a deliberate plan to remove assets from the second company and to avoid tax. It was held that the acquisition of the controlling interest in the appellant company did not give rise to a presumption of business activity. Regardless of the nature of the profits, in the hands of the

second company, there was no way by which the same could be treated as arising from underwriting transactions in the hands of the appellant.

In determining whether or not a gain is of a capital nature, the courts do not seem to give much weight to fact that the shares were purchased with borrowed money or out of personal funds.[209] The fact that a private company is compelled to sell its shares to the public due to some financial difficulties does not change the nature of the shares of being, by itself, an investment and a potential source of revenue.[210]

However, if the taxpayer is a dealer in securities, profits arising from the acquisition, exchange, and disposition of shares will, most likely, be considered as income from trading operations.[211]

Moreover, if the transaction is an adventure in the nature of trade, the fact that payment was made in corporate shares, unless the same was made by way of compensation for the loss of a capital asset, does not exempt the taxpayer from income tax.[212] Furthermore, if the sale of the shares of a company, havingas its main asset a parcel of land, resulted in some profits, the said profits are taxable as ordinary income.[213] In this instance, the sale of the shares is treated as the sale of the land.

The rule with respect to mortgage transactions in relation to the question whether a gain is of the capital variety or taxable business income is different from those affecting securities transactions.

Hence, in M.N.R. v. Beatrice Minden,[214] the respondent, through her husband and his partner, purchased several agreements for sale and mortgages at discounts. After complete payment on the agreements and the mortgages, the profits on the same were taxed by the Minister. The respondent contended that the transaction involved the purchase of investments and, therefore, a mere realization of capital assets. It was held that the profit was taxable. The Court explained that the transaction was not one involving a person who acquires an investment and, upon choosing to realize on it, obtains a greater price than the acquisition cost. Here, there was no enhancement of the value of the subject matter of the transaction. Moreover, it was stated that agreements and mortgages are not matters which an ordinary and prudent investor would consider as an investment. Furthermore, there was even no attempt to collect any interest. The respondent was satisfied with the discounts. Therefore, the respondent, through her husband and his partner, was deemed as having embarked upon a scheme for profit making constituting a gain made in the operation of a business.

It should be noted that there is a pending proposal before the Canadian Parliament for the taxation of capital gains.[215] If the proposal is enacted into law, as a general rule, only one-half of the capital gains would be taken into income.[216] There is also a recommendation to tax one-half of the gains of closely held corporations on the sale of shares.[217] The proposed legislation will not affect the present jurisprudence regarding the distinction between business income and capital gains.

3. Items Excluded From Gross Income

There are certain specific items which are excluded from gross income for tax purposes. The reasons for the exclusions vary. As a general rule, the exlusions are based on broad policy considerations directly or indirectly linked with the social, political, and economic life of a people. With respect to certain items, the reason is simply because another type of tax, such as inheritance tax, is imposed on the same.

FRANCE

In France, the specific items excluded from the gross income are the following: i) property acquired by an individual as an inheritance or gift; ii) proceeds of life insurance, unless received by a business enterprise; iii) certain welfare and security payments; iv) military pen-

sions and pensions to civilian victims of war; v) deferred wages, due after death of a farmer, to descendants over the age of 18 who worked on the farm during the farmer's lifetime without receiving wages or sharing in the profits or losses; vi) capital sums paid by an employer to an employee on the latter's retirement up to a maximum of 10,000F; vii) annuity paid to individuals as a result of accident; viii) indemnities for injuries suffered during the war and occupation; ix) interests on some government bonds, deposits in caisses d'epargne (savings bank), and securities for the development of the French capital market up to a maximum of 500F per year; x) amounts taxed in the hands of a corporation are sometimes free of tax in the hands of the recipients; xi) certain capital receipts as previously discussed.[218]

UNITED STATES

In the United States, the specific items excluded from gross income are the following: i) payments in the nature of welfare and public assistance, such as social security benefits, unemployment compensation, public relief, and aid to the blind; ii) receipts which represent a recovery or replacement of capital, such as the repayment to the lender of a loan; iii) gifts and inheritance; iv) proceeds of life insurance; v) employee benefits and other wage and salary supplements; vi) military benefits; vii)

dependent's earnings; viii) old-age benefits; and, ix) investment and natural resources exempt items.[219]

PHILIPPINES

In the Philippines, the specific items exempt from income taxation are the following: i) life insurance proceeds; ii) amount received by the insured as return of premium; iii) gifts, bequests, and devises; iv) compensation for injuries or sickness; v) interest on government securities; vi) income exempt under treaty; vii) income of certain foreign governments in the Philippines; and, viii) income exempt under certain public laws.[220]

CANADA

In Canada, the specific items not included in computing income are the following: i) an amount that is declared to be exempt from income tax by any other legislation of Parliament; ii) amount received from certain War Savings Certificate; iii) subject to certain conditions, the income for the year of a non-resident person earned in Canada from the operation of a ship or aircraft; iv) certain specified pensions and compensations; v) social assistance payments; vi) benefits received under unemployment insurance; vii) payments from an employee's sharing plan; viii) certain amounts received as a result of prospecting; and, ix) income and allowance of certain public officials.[221]

It should be noted that, under Section 71A, ITA, the income of a taxpayer from a manufacturing or processing business in a designated area during a fiscal period of the business occurring wholly within the 36 months period that commenced on the day certified as the day on which the business commenced manufacturing or processing in reasonable commercial quantities is not included in computing gross income.

Likewise, in accordance with Section 83(5), ITA, income derived from the operation of a mine during the period of 36 months commencing with the day on which the mine came into production is not included in computing the gross income of a corporation. Section 83(6) provides that a "mine" does not include an oil well, gas well, brine well, sand pit, gravel pit, clay pit, shale pit or stone quarry (other than a deposit of oil shale or bituminous sand, but does include a well for the extraction of material from a sylvite deposit and all such wells, the material produced from which is sent to a single plant for processing, shall be deemed to be one mine. The same provision defines "production" to mean as "production in reasonable commercial quantities".

In the North Bay Mica Co. Case,[222] it was declared that "coming into production" includes the reopening of an

abandoned mine. The extraction of ilmenite by open-pit method to be used for ballast constituted mining,[223] moreover.

In Gunnar Mining Ltd. v. M.N.R.,[224] it was held that income arising out of investments purchased from mining profits is not income from the operation of a mine.

D. GROSS BUSINESS INCOME DISTINGUISHED FROM OTHER CATEGORIES

FRANCE

In France, aside from business income, as previously discussed, there are other categories of income, such as income from farming and forestry, income from real property, income from employment, income from non-commercial activities, and income from securities and similar income from capital. For purposes of this thesis, income received by executives of certain closely held frims will be considered as falling under income from employment.

Income from farming and forestry is not considered as income from business. In general, farming and forestry income is determined by a system of national assessment and is computed at a lower valuation as compared to other profits.[225]

It is easy to distinguish between income from farming and income from business. It is explained in this manner: "Income from agriculture consist primarily of income from the sales of products grown or raised on the farm. If

retail sales of products grown on the farm are made at the farm proper, income from such sales is income from agriculture. Only if sales are made at a separate establishment located away from the farm is such income business income."[226]

Generally, a person who limits transformation or processing to products of his own harvests, and whose processed products serve as food for man or beast or as raw materials in agriculture or industry, is considered to derive income from agriculture rather than business. In C.E. 21 March 1953 No. 13,904, a farmer owned a farm covering about 532 hectares, of which 85 were devoted to growing peas. The farmer canned his whole pea crop in a factory which operated 4 weeks a year. He never purchased pea for processing in his factory. It was held that the factory operation was a normal prolongation of agricultural activity. Therefore, the income of the factory was deemed agricultural. However, in R.M. 9,590, J.O. 5 November 1960, Deb. A.N., p. 3140, the income of a person who manufacture canned fruit juice was, without regard to the source of the fruit, adjudged as coming from business. In reaching the above decision, much emphasis was placed on the nature of the operation and the amount of equipment required.

Income from non-agricultural real property, rented or

leased by the owner to others, is taxed as income from real property.[227] The ownership and management of real property by a person is not regarded as business activity.[228] However, if the real property is leased to another together with equipment and machinery for operation as business or if property is devoted by the individual to a commercial or industrial activity carried on by him, income from the same shall be considered as coming from business.[229]

Income from employment is defined to include traitements (salaries), salaires (wages), indemnites (allowances), emoluments (emoluments), pensions (pensions), and rentes viageres (annuities).[230]

Income derived from an independent activity that is industrial or commercial is taxed as income from business rather than employment.[231] The exceptions to the said rule are: i) payments to cottage and home workers; ii) fishermen working shares; iii) payments to certain branch store managers who receive percentages profit rather than fixed salaries; and, iv) compensation paid to travelling salesmen.[232] All the foregoing, are by definition, specifically treated as wages although the payments are actually business income from independent activity.

The income received by an executive of closely held firms will be discussed in connection with the deductibility

of compensation for services rendered.

Income from the independent practice of a liberal profession by an individual is treated as income from a non-commercial activity.[233] All income not classified as income belonging to a specific category is considered as taxable non-commercial income.[234] An example would be income arising from habitual transactions in securities. As previously explained, under Article 34, CGI, the income of artisans is not considered as falling within the category of income from a non-commercial activity but taxed as business income. Royalties received by a third party, whether an individual or a corporation, who has purchased a patent from the inventor are taxed as business income.[235] Nevertheless, royalties received by an individual inventor are taxed as income from a non-commercial activity.[236]

The distinction between business income and income arising from the sale of capital assets was already discussed in connection with capital gains.

UNITED STATES

In the United States, due to the global-unitary character of its tax system no distinction is made between business income and income from other categories for purposes of computing the taxable income or imposing the tax.

PHILIPPINES

In the Philippines, since its tax system is identical to that of the United States, there is also no distinction made between income from business and income from other categories for purposes of imposing the tax on income or computing the taxable income.

CANADA

As previously discussed, Section 3, ITA, classifies income into business income, property income, and income from office and employment. The reason for the difference in the number of income categories in France and Canada can be explained by the fact that capital gains are not taxed in Canada. Moreover, the "other income" categories in France fall either under business income, property income, or income from office and employment in Canada. It is respectfully submitted that Canada's classification, as compared to France, is less complicated and more practical for purposes of tax administration.

Even if the taxpayer does not carry on business, the property he owns may earn income.

"Property" is defined by Section 139 (1) (ag), ITA, to mean "property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right

Thus, "property" covers all forms of tangible property both real and personal, and also intangible property such as patents and copyrights, bonds, shares and other forms of security. Negotiable instruments, including money, may also give rise to income which may be classed as income derived from property.

In the No. 727 case,[237] engineering contracts transferred by the taxpayer to a company which he controlled were not considered as property. It seems that the decision in this case is erroneous because the transfer of the engineering contracts constituted a transfer of rights. However, in Eastern Estate v. M.N.R., 49 D.T.C 491, it was held that the right to receive money is property.

Income from property may come in the form of rent, royalty, dividend, interest, or some other payments. The important thing, however, is that it should be income not arising from business.

A portion of the income from business, normally, represents income from the property investment used in the business.[238] Where the property used in the business is owned by the person conducting the business, a portion of the income will represent yield from the property in question.[239] Nevertheless, where by rental agreement, business property is entrusted to the custody and control of

an outside entrepreneur, the payment received for its use will solely be attributable to ownership of the property and will be considered as income from property rather than business.[240]

No. 196 v. M.N.R.[241] best illustrates the distinction between business and property income. In the said case, the appellant was the principal shareholder of two private companies owning 2 commercial buildings and an apartment. It was established that the appellant took an active part in the affairs regarding the commercial buildings and the apartment. The Minister treated the two private companies as the appellant's personal corporations and added the income of the companies to those of the appellants for purposes of imposing the tax. It was held that the corporations were engaged in business and that their income could not be added to those of the appellant. It was pointed out that a personal corporation does not carry on an active financial, commercial or industrial business. Here, the companies were actively engaged in the management and maintenance of the buildings and the apartment. Moreover, unlike securities, commercial buildings do not take care of themselves. There is a necessity to manage, supervise, and supply the same.

Let us now discuss what is income from an office and

employment.

Section 139 (1) (e), as previously explained, excludes an office or employment from the meaning of "business". Hence, income arising from an office and employment is not income from business.

Section 5, ITA, states that the income for a taxation year from an office and employment is the salary, wages and other remuneration, including gratuities, received by the taxpayer plus (a) subject to certain exceptions, the value of the board, lodging and other benefits of any kind whatsoever received or enjoyed by him in the year in respect of, in the course of, or by virtue of the office or employment, and (b) subject to certain exceptions, all amounts received by him in the year as an allowance for personal or living expenses or as an allowance for any other purpose minus the deductions permitted by paragraphs (1), (ib), (q) and (qa) of subsection (1) of Section 11 and by subsections (5) to (11), inclusive, of Section 11 but without any other deductions whatsoever.

For a proper understanding of Section 5, it is essential to know the meaning of "office" and "employment".

Section 139 (1) (ab), ITA, defines "office" as "the position of an individual entitling him to a fixed or ascertainable stipend or remuneration and includes a jud-

icial office, the office of a Minister of the Crown, the office of a member of the Senate or House of Commons of Canada, a member of a legislative assembly, senator or member of a legislative or executive council and any other office, the incumbent of which is elected by popular vote or is elected or appointed in a representative capacity and also includes the position of a corporation director". The same Section defines an "officer" as "a person holding such an office".

"Employment" is defined as the "position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign). "Servant" or "employee" means "a person holding such position". Section 139 (1) (l), ITA, defines "employed" as "performing the duties of an office or employment". "Employee" is defined to include officers.

The above definitions emphasize two important factors in determining whether an income is from office or employment, as follows: i) a position conferring entitlement to a fixed or ascertainable remuneration; or ii) a position in someone's service. It should be noted that the presence of either of the said factors is sufficient to establish that an income is from office or employment.

In connection with the element of remuneration, a

distinction must be made whether the amount is awarded for services or as a mere recognition of services. In the latter case, the award is considered as a personal gift and, hence, not subject to tax.

Seymour v. Reed, [1927] A.C. 554, is illustrative of the point under consideration. Here, the appellant was a professional cricketer. The cricket club to which he belonged granted him a benefit match. The proceeds of the match together with public subscriptions were invested in the names of the trustees of the club. The income arising from the investment was paid to the appellant. Later, the investment was realized and the proceeds therefrom were utilized to purchase a farm for the appellant. In holding that the proceeds were given as a personal gift, the House of Lords stated:

> "A benefit is not usually given early in a cricketer's career but rather towards its close in order to provide an endowment for him or retirement. Its purpose is not to encourage the cricketer to further exertions but to express the gratitude of his employers and the cricket-loving public for what he has already done and their appreciation of his personal qualities. ... The whole sum -- gate and subscriptions alike--is a testimonial and not a prerequisite. In the end--that is to say when all the facts have been considered--it is not remuneration for services but a personal gift.

In Dr. Blatz v. M.N.R.,[242] a medical doctor and university professor of medicine was engaged at a specified

fee to give a series of lectures at another university for a period of six weeks. It was not clearly pointed out whether the income was either from "office" or "employment". Nevertheless, because the factor of fixed or ascertainable remuneration was present, the income was classified as arising from office or employment. Guerin v. M.N.R.[243] defines "fixed or ascertainable income" as income from a position that, when accepting it, a person knows exactly how much he will receive for the services he is called to render.

With respect to the factor that a person should hold a position in the service of another to be considered as an employee, the matter is aptly and succintly described by Professor Jones in his article: "Benefits Under the Income Tax Act", No. 2, Vol. VI, Alberta Law Review (1968), as follows: "The best expression of the problem is to attempt to ascertain whether an amount received by an individual is under an express or implied contract for service which would count as remuneration to an employee or whether it is received under an express or implied contract for services and thus would represent a business or a profession. The question depends on whether or not a master-servant relationship exists between payor and payee." (Underscoring Supplied).

The concept of a "master-servant relationship" is explained in DiFrancesco v. M.N.R., [1964] 34 Tax A.B.C. 380, as follows:

> "A servant (employee acts under the direct control and supervision of his master, and is bound to conform to all reasonable orders given him in the course of his work; an independent contractor, on the other hand, is entirely independent of any control or interference, and merely undertakes to produce a specified result, employing his own means produce that result .... To distinguish between a contractor and a servant (employee), the test is whether or not the employer retains the power, not only in directing what work is to be done, but also of controlling the manner of doing the work."

Thus, doctors supplying medical services under contract to municipalities but remaining free agents are not considered as employees.[244] Likewise, free-lance musicians and actors are not considered as employees.[245] However, musicians and actors subject to the control of the persons hiring them are employees.[246]

In a case,[247] a practising physician was connected with a hospital as head of a department under a contract entitling him to a fixed annual payment. He had specific duties and responsibilities and was granted the liberty to practise medicine. It was held that his income arose from employment. The Board explained that fees of the retainer type apply only to lawyers and not to doctors.

It should be emphasized that the non-payment of

unemployment insurance and non-eligibility for holidays do not imply that there is no employment.[248] As already explained, the important question is whether or not the employer exercised control over the person claiming to be an employee.

E. TAXABILITY OF SPECIAL RECEIPTS

There are receipts of certain business enterprises or entities that should be discussed separately because of their peculiar character. The more important of them are: i) accumulated profits; ii) receipts of personal holding companies; iii) receipts of investment companies; iv) receipts of banks; v) receipts of insurance companies; vi) receipts of real property investment trusts; and, vii) receipts of private educational institutions.

The ensuing discussions will be limited to a consideration of the manner the enumerated receipts are taxed in the countries under comparative analysis. The similarities and differences will also be pointed out. The question whether or not a specific tax treatment adopted by any of the countries is good and beneficial to it will be considered later.

1. Accumulated Profits

FRANCE

In France, as a general rule, there is no tax on

corporate accumulations. However, in 1963, a tax of 1.5% was imposed on accumulated corporate profits that had not been incorporated into capital.[249]

UNITED STATES

Unlike France, in the United States, accumulated earnings are subject to additional tax.

Under Sections 531 to 537, IRC, an additional tax is imposed on corporate income where the corporation is used to avoid the income taxation of its shareholders by permitting earnings and profits to accumulate instead of being distributed. Under Section 531, IRC, the tax rate of 27.5% is imposed on the corporation's accumulated taxable income not in excess of $100,000 plus 38.5% of such income in excess of $100,000.

The term "accumulated taxable income" is defined as "the taxable income with certain adjustments, including principally a deduction for dividends paid during the taxable year."[250] It is determined as follows: "In computing accumulated taxable income, a credit is allowed for an amount equal to such part of the year's earnings as is retained to meet the reasonable needs of the business, but not less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceeding taxable year. Thus, the corporation

may accumulate up to $100,000 without fear of tax."[251]

Finally, in the taxation of accumulated earnings, the following rules should be remembered: 1) the tax is imposed on the accumulated taxable income of the current year only; 2) the tax is, not in lieu of, but is in addition to, the regular tax imposed on corporate income under Section 11, IRC; and, 3) the tax has no application to personal holding companies, foreign personal holding companies, or corporations which are exempt from tax under Section 501 et seq. of the IRC.[252]

PHILIPPINES

As in the United States, in the Philippines, accumulated profits are also taxed. Under Section 25, NIRC, an additional tax of 25% is imposed on the undistributed portion of the accumulated profits or surplus of a corporation, except banks, insurance companies, or personal holding companies, whether foreign or domestic. It should be noted that, as in the United States, the tax is in addition to the corporate tax imposed under Section 24. The additional tax is imposed if the corporation is formed for the purpose of preventing the imposition of the tax upon its shareholders or members or the shareholders or members of another corporation through the medium of permitting its gains and profits to accumulate instead of being divided or distributed.

Section 25, NIRC, places on the taxpayer the burden of showing that the accumulation, if any, is not for the purpose of avoiding the imposition of tax on the individual shareholders. However, the Section does not describe what details should be proven.

In this regard, the most important problem relates to what constitutes "reasonable accumulation". Reasonable accumulations or accumulations to cover the particular needs of a business are not subject to the additional tax. Section 25 declares that the tax is 25% of the undistributed portion of the acccumulated profits or surplus. Due to lack of statutory definition of accumulated surplus, presumably the accounting concept will be used, i.e., all the accumulation found at the time of the examination, and the 25% tax will be based on the said aggregate sum.[253] The Bureau of Internal Revenue has ruled in this connection, however, that "undistributed surplus" refers to the yearly surplus and that once an accumulation has been taxed, it will not be taxed again in a subsequent examination.[254] Previous accumulation even beyond the prescriptive period may be examined to determine reasonableness in relation to to the needs of the business.[255] It should be noted that, in the United States, not the entire accumulation within the year is taxed but only that portion which is determined

to be unreasonable. In the Philippines, there is the view that, once it is determined that the accumulation is unreasonable, the entire accumulation for the taxable year is subject to the additional tax.

Lastly, the additional tax is not levied upon the accumulated profits or suplus if they are invested in any Dollar producing or Dollar saving industry or in the purchase of bonds issued by the Central Bank of the Philippines in accordance with Republic Act No. 1823. The United States does not have any provision similar to this.

CANADA

In Canada, there is no additional tax on undistributed profit like those obtaining in the United States and the Philippines. Canada attempts to solve the problem of corporate accumulations in a different manner. In accordance with Section 105, ITA, it grants corporations the privilege to be taxed at a much lower rate on dividends declared out of undistributed profits.

2. Receipts of Personal Holding Companies

FRANCE

France makes no distinction whether holding companies are personal or not. Moreover, holding companies, in France, are not subject to special tax rules as in the United States and the Philippines.

France attacks the matter of profit accumulations through personal holding companies from a different perspective. It is of the belief that, by the grant of certain incentives, corporations will no longer accumulate profits.

Thus, parent or holding companies are given a favorable tax treatment in the event of redistribution of proceeds received from subsidiaries. Companies which are deemed to be parent or holding companies for tax purposes have the privilege of being able to deduct from their taxable profits the dividends which they obtain from their subsidiaries.[256] Since, dividends received from a subsidiary escape corporate tax, the distributions by the parent company are liable to levy as far as they are deemed to represent these items of profit.[257] Nevertheless, parent or holding companies are entitled to deduct from the levy on dividends thus payable the amount of the tax which would have been imposed upon their subsidiaries on the proceeds they received during the financial year subject to the following conditions: a) the holding company must be a French corporation holding at least 10% of the capital of the other company or a holding cost of more than 10 million Francs: b) the holding company must not be an investment company; and c) the holding company must undertake to retain the holding for not less than two years.[258] In this manner, holding companies are able

to distribute to their shareholders tax free a sum equal to the dividends they received from their subsidiaries.

UNITED STATES

Unlike France, in the United States, there are special charging rules for the taxing of personal holding companies.

Sections 541 to 547, IRC, impose a special penalty tax on corporations that are classified as personal holding companies. The personal holding company tax is directed against corporation owning investment assets, such as stocks, bonds, and real estate.

The penalty tax was enacted due to the rampant utilization of certain tax-saving arrangements which were designed to use the corporate form as a means of shielding the individual shareholder from the tax that he would otherwise incur on income derived from his investments of personal services.[259] One arrangement involved the creation of a corporation by an individual to hold his investment securities and to obtain and accumulate the dividends and interest therefrom, so that such income would be taxed at the flat corporate rate rather than at the progressive individual rates.[260] Another situation is the use of a wholly owned corporation to "hire" its shareholder, say, a movie star, at a relatively low salary. The corporation would then resell the shareholder's services for an amount

equal to their real value.[261] Thus, the difference between the amount received and the amount paid out would be taxed at the corporate instead of the individual rate.

Unlike the accumulated profits tax, the personal holding company tax "does not depend on the need, reasonableness, or purpose of the accumulation, but instead is applied automatically...."[262]

The tax is levied at a rate of 75% on the corporation's "undistributed personal holding company income" not in excess of $2,000, and at a rate of 85% on such income in excess of $2,000."[263]

A corporation is deemed to be a personal holding company if it falls within certain statutory conditions involving: (a) stock ownership; and, (b) gross income. The stock ownership test states that, if more than 50% in value of the corporation's outstanding stocked are owned, directly or indirectly, by or for not more than five individuals at any time during the last half of the taxable year, the corporation is considered a personal holding company.[264] Under the gross income test, "at least 80% of the corporation's gross income must consist of "personal holding company income", which includes dividends, interest, royalties, personal service income, rents (unless constituting 50% or more of the corporation's gross income), and gains

from the sale of securities.[265] It should be noted that the tax is on the current year's taxable income, reduced by taxes, dividends, and certain other items.

Under the IRC, no income tax is imposed on foreign personal holding companies.[266]

PHILIPPINES

In the Philippines, as in the United States, a tax is imposed on personal holding companies in addition to the regular corporate income tax rates. The personal holding company is subject to a tax of 45% of its undistributed net income.[267]

Many individuals, belonging to high income tax brackets, organize corporations to hold their investments, because, until such time as the corporation distributes the corporate profits as dividends to the stockholders, the corporate income would be taxed only at lower corporate income tax rates. Furthermore, with respect to dividends received by a domestic corporation from another domestic corporation subject to income tax, as previously discussed, only 25% of the dividend is taxable, so that 75% is received tax-free. Corporations are also allowed to deduct the full amount of interest they incur on loans secured in the acquisition of investment.[268] These are the reasons why an additional tax was imposed on personal holding companies.

As in the United States, in the Philippines, a corporation is considered a personal holding company if two requisites relating to stock ownership and income of the corporation are present. If the shares of stock of the corporation or if more than 50% in value of its outstanding shares of stock is owned directly or indirectly by or for not more than five individuals and if at least 80% of its gross income for the taxable year is personal holding company income, then the corporation is a personal holding company.[269] Once a corporation is classified as a personal holding company, it will be considered as such in subsequent years if 70% of its income is "personal holding company income".[270] Moreover, under the NIRC, once a corporation is classified as personal holding company, it remains a personal holding company subject to penalty tax until a taxable year when during the entire last half of that year less than 50% of its stock is owned by or for not more than five individuals or until three consecutive taxable years have expired or lapsed in each of which less than 70% of the gross income of such corporation is personal holding company income.[271]

In the Philippines, as in the United States, the stock-ownership requirement refers not only to direct ownership but also to indirect ownership. Thus, the stock that is owned directly or indirectly by or for a corporation, an

estate, or a trust is deemed as being owned proportionately by the shareholders, the partners or the beneficiaries.[272] An individual is also considered as owning that which is directly or indirectly owned by or for his family, or by or for his partners.[273] Likewise, an option to acquire shares of stock or an option to acquire said option is considered stock ownership.[274]

The income items that are considered personal holding company income are: dividends, interests, royalties, gains from sales of securities, gains from transactions in commodities, amounts includible in computing the net income of the estates and trusts, amounts received as income or compensation under personal service contracts if certain conditions are met or exist, rentals from the use of corporation property by a stockholder, rents unless they constitute 50% or more of the gross income of the corporation's gross income, and mineral, oil or gas royalties unless they constitute 50% or more of the gross income of the corporation and the deductions relating to expenses other than compensation for personal services constitute 15% or more of the gross income.[275]

CANADA

In Canada, as in France, there is no additional tax imposed on the income of personal holding companies as those

existing in the Philippines and the United States. The closest to a personal holding company in Canada is the so-called "personal corporation". However, as discussed earlier, "personal corporations" are, for purposes of income taxation, treated differently.

3. Receipts of Investment Companies

FRANCE

In France, the important types of investment companies are the societes prives d'investissement a capital fixe (close-end investment companies) and societes d'investissement a capital variable (open-end investment companies).

Societes prives d'investissement a capital fixe are investment companies employing a fixed amount of capital. Under Article 208-1, 1^{0}bis A, CGI, said investment companies are exempt on their dividends and interest receipts and on their capital gains from security sales. Dividends and interests paid to an investment company by companies whose securities the investment company holds are subject to the normal withholding of income tax. But dividends distributed by the investment company to its shareholders, either from its dividend receipts, capital gains or interest receipts, are exempt from withholding at source. Furthermore, although the shareholders of the investment company include their dividend receipts as taxable income, they are "entitled

to credit, against their tax due, an aliquot share of the sum withheld at the source on the dividend and interest payments received by the investment company."[276]

To be deemed a close-end investment company, an investment company must: i) limit its activity to the ownership and management of a portfolio of corporate securities; ii) have a fully paid minimum capital of 2,500,000 Francs; iii) not invest more than 5% of its capital in the shares of any one company nor own more than 10% of the shares of any one company; and, iv) not pay to directors profit-sharing allowances exceeding 5% of the net income.[277]

Open-end investment companies or societes d'investissement a capital variable are established with the permission of the French Minister of Finance.[278] Despite any contrary provisions under the corporation law, open-end investment companies may increase their capitalization or decrease it by repurchasing outstanding shares on demand.[279]

Open-end investment companies enjoy the same benefits as the close-end investment companies.[280] Furthermore, under Article 144-2, CGI, there is no withholding of tax at the source when it reacquires its own shares. To be entitled to all the benefits available, the open-end investment company should satisfy the following requirements: i) its initial capital must not be less than 20,000,000 Francs;

ii) its capital cannot be reduced below 10,000,000 Francs, iii) at least 30% of its assets must be kept in cash, bank deposits, short-term government securities, and Franc bonds issued to the general public or quoted on a security exchange; iv) at least 90% must be kept in cash, deposits, short-term government securities, and securities issued to the general public or quoted on an exchange; and, v) its capital gains must be put in a reserve for capital losses until the reserve equals the value of 10% of the portfolio.[281]

The tax benefits available to close-end and open-end investment companies are also granted to other investment entities set up for specific purposes favored by the government.[282] Among them are societes anonymes de financement de recherches et d'exploitation des gisements d'hydrocarbures liquides ou gazeux (entities to finance petroleum exploration and development), companies organized to foster regional development, societes financieres pour le developpement economique outre-mer, (companies to foster the economic development of France's overseas departments), societes sahariennes de developpement (companies set up to foster development of the Sahara), and societes immobilieres d'investissement (real property investment companies).[283]

Foreign investment companies in France are taxed as ordinary foreign corporations.

UNITED STATES

Investment companies in the United States are accorded more benefits than those in France.

Sections 851 to 855, Subchapter M, IRC, grant special treatment to certain investment funds which qualify as belonging to "regulated investment companies". The said investment companies are in effect relieved of liability for corporate tax with respect to ordinary income and capital gains from their securities investments if this income is currently distributed to their shareholders. The regulated investment company is, thus, treated as a conduit rather than as a taxable entity despite the fact that these companies are conducted in corporate form. It is designed to remove any differential in tax cost to the individual investor as between investing directly in corporate securities and acquiring a participation in the investment firm and, hence, indirectly in its securities portfolio.[284]

The majority of the investment companies are of the open-end type. It simply means, as in France, that an individual investor acquires an interest in the corporation by purchasing newly issued shares on original issue from the company itself, and can withdraw by presenting his stock to the company for redemption in cash at current market value.[285] The corporation is at any time ready to issue

new stocks or redeem outstanding stocks so that the capital structure is in a state of constant flux.[286] Companies of the close-end type, as in France, are corporations with "a fixed capital structure and their shares normally may be obtained only from other shareholders by purchase, frequently, on a national stock exchange.[287]

In order that a corporation may qualify as a regulated investment company entitled to all the benefits described above, the following requirements must be satisfied: i) it must be registered with the Securities and Exchange Commission under the Investment Act of 1940; ii) it must not be a personal holding company; iii) at least 90% of its income must be derived from dividends, interest, and gains on sales of securities, with a limitation on the amount permitted to be derived from the rapid turnover of securities; iv) the company's investments must be diversified; v) the company may not acquire more than a 10% interest in the securities of any single operating company; and, vi) it must distribute to its shareholders as currently taxable dividends at least 10% of its net income, exclusive of net long-term capital gains.[288]

A regulated investment company is allowed a deduction for dividends paid to ist shareholders.[289] It is, thus, taxed at regular corporate rates only on the amount of its

income which is not distributed.[290] However, it is not allowed the 85% intercorporate dividends deduction.[291] The amount distributed by the company as a dividend is taxed to the individual shareholders in the year in which the distribution is made. The said dividends are, generally, subject both to the $50 annual exclusion and the 4% dividends received credit.[292] These matters will be discussed later.

If the regulated company distributes currently all or a part of its net long-term capital gains, the distribution will be taxed as a long-term capital gain to the shareholders rather than as an ordinary dividend.[293] Undistributed net long-term capital gain is taxed to the company at the rate of 25%.[294] However, the company may make "constructive capital gain distribution" by so informing each shareholder. The mechanism of the same is explained as follows: "The shareholder is ... required to include the amount designated by the company as constructively distributed in his gross income as a long-term capital gain. But he is also regarded as having paid the 25% capital gains tax thereon and hence entitled tocredit his share of the tax paid by the company against his individual tax liability ... To prevent a second capital gain tax on the sale of his investment company stock, the shareholder increases his basis for the stock by 75% of the constructive distribution."[295]

If more than half of the assets of a regulated company are invested in the securities of a foreign corporation, the foreign tax credit otherwise allowable to the company as to its income from such securities is allowed as a credit to shareholders to whom such income is currently distributed.[296]

In the United States, "real estate investment trusts" are subject to substantially the same tax treatment as regulated investment companies.[297]

Foreign investment companies, ordinarily, are not subject to income tax because it holds no United States securities and, therefore, has no United States source income. However, Section 1246, IRC, provides that gains on the sale or exchange of stock in a foreign investment company shall be taxed at ordinary income rates. Hence, shareholders of foreign investment companies do not get any undue advantage.

PHILIPPINES

In the Philippines, Section 20 of Revenue Regulations No. 2 defines an investment company as one whose activities are not only that of a mere holding company, but further include the buying and selling of stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived

not only from the investment yield but also from profits upon market fluctuations.

Investment companies in the Philippines are taxed as ordinary corporations depending upon whether it is domestic or foreign. It is subject to the additional tax imposed on personal holding companies if it is classified as such. No distinction is made between open-end and close-end investment companies for tax purposes.

There are no "real estate investment trusts" in the Philippines similar to those existing in the United States and France. However, for the purpose of encouraging the construction of houses and buildings, building and loan associations, created in accordance with the Philippine Corporation Act, are taxed at the reduced rate of only 12% on their income.[298]

CANADA

In Canada, under Section 69 (1), ITA, the tax rate for investment companies is non-progressive and at the low level of 18%. The said companies must, however, also pay the 3% Old Age Security Tax.

Considering the 20% dividend tax credit in the taxing of its shareholders, any double taxation of investment income derived through an investment corporation is virtually eliminated for investors in higher tax brackets.[299]

Inter-corporate dividends received by an investment corporation are also excluded from its taxable income.[300]

Under Section 69 (2), ITA, an investment company means a corporation complying with the following conditions: i) at least 80% of its property must be shares, bonds, marketable securities and cash throughout the taxation year; ii) not less than 95% of its income for the year must be derived from shares, bonds, and marketable securities; iii) not less than 80% of its gross revenue must be from sources in Canada; iv) not more than 25% of its gross revenue for the year can be from interest; v) at no time in the year can more than 10% of its property consist of shares, bonds, or securities of any one corporation or debtor, other than the government of Canada, or a Canadian province or municipality; vi) at no time in the year can the number of shareholders of the corporation be less than 50 and none of them can at any time in the year hold more than 25% of the shares of the capital stock of the corporation; and, vii) not less than 85% of its taxable income and exempt income for the year, except dividends or interests received in the form of shares, bonds or other securities, that have not been sold before the end of the taxation year, minus 21% of its taxable income for the year and taxes paid to other governments must have been distributed to shareholders before

the end of the year.

It should be noted that, in Canada, as in the Philippines, there are no separate rules pertaining to open-end and close-end investment companies. "Real property investment trusts" in Canada are not treated in the same manner as the said entities are treated in France and the United States. The said entitites are taxed as trusts under the ITA.

There are different rules for the taxation of non-resident (foreign) owned investment corporations. The income tax rate for non-resident-owned corporations is only 15%. However, it is not allowed to deduct from income capital items such as foreign taxes paid and interest on its bonds, debentures, securities or other indebtedness. Moreover, different percentages are required with respect to stock ownership and amount of revenue from certain types of properties in the case of non-resident-owned investment corporations. The special rules applicable to said corporations are found in Section 70, ITA.

4. Receipts of Banks

FRANCE

In France, as a general rule, corporate income tax provisions apply to banks in the same manner as it is imposed upon other corporations.[301] However, there are some minor variations. Banks are permitted to deduct from

taxable income certain sums set aside as reserves to meet special risks of medium-term and long-term loans. With some exceptions, the amount deducted should not exceed 5% of the taxable income in any year and the amount on reserve should not exceed 5% of the outstanding medium-term and long-term loans.[302] Ordinarily, banks are allowed a credit for income tax withheld at the source like other corporations. The exception is with respect to interest on government bonds which are exempt from withholding at source. Corporations usually claim a "fictitious credit" against their income tax as if tax had been withheld at source.[303] The right to claim a "fictitious credit" does not apply to banks. Under Section 2, CGI, interests on government bonds are fully taxable in the hands of the banks.

UNITED STATES

In the United States, banks receive a more favorable treatment for tax purposes as compared to France. Banks are subject to tax at the same rates as other corporations and compute their taxable income in the same manner. Nevertheless, a bank is not limited to capital loss deduction[a] for losses resulting from worthlessness of bonds, debentures, and other debt securities but may treat such securities as bad debts and, hence, as ordinary losses in accordance with Section 582 (a), IRC. Banks like other corporations,

are allowed a reasonable allowance for bad debts under the reserve method, or they may write off bad debts losses as they occur. Furthermore, under Revenue Ruling 54-148, 1954-1 CB 60, commercial banks employing the reserve method for bad debts may deduct up to three times their average loss experience factor during any consecutive 20-year period after 1927.

PHILIPPINES

In the Philippines, banks are given almost the same kind of favorable treatment as those in the United States. As in the United States, Section 30 (e) (3), NIRC, it is provided that if any securities as defined in Section 84 are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall in case of banks be treated as ordinary loss. Furthermore, as already mentioned earlier, banks are not subject to the additional tax on accumulated profits.

CANADA

In Canada, for income tax purposes, banks are treated as other ordinary corporations. However, in accordance with Section 9, ITA, there shall be included in computing the income of a bank for a taxation year, the amount by which the aggregate of the amounts that, at the end of

the year, are set aside or reserved by way of write down of the value of assets or appropriation to contingency reserves or contingent accounts for the purpose of meeting losses on loans, bad or doubtful debts, depreciation in the value of assets other than bank premises, or other contingencies, which is, in the opinion of the Minister of Finance having regard to all the circumstances, in excess of the reasonable requirements of the bank. Thus, to the extent that the reserves or the amount set aside are not in excess of the reasonable requirements of a bank, the same are not included in computing the income of the bank.

5. Receipts of Insurance Companies

FRANCE

In France, for purposes of fixing liability and computing taxable income, life and non-life insurance companies are treated in the same manner.

Subject to certain special provisions, the income of insurance companies are taxed just as other corporations. However, insurance companies are by law required to maintain reserves sufficient to meet their obligations. The sums set aside for mandatory reserves are deductible from income. The deductibility of amounts allocated as optional reserves, such as reserve pour risques en cours (reserve to meet pending claims), depend upon the ordinary rules rela-

ting to business reserves. In accordance with Article 39-1 to to 5, CGI, only amounts in a reserve to meet losses or expenses that may be specified and the eventual payment of which is made probable by actual occurrences are deductible. Hence, in C.E. 30 July 1951, No. 2,212, a credit insurance company was denied deduction of amounts placed in an optional guaranty reserve in the event of economic crisis. A casualty insurance company was also denied deductions for sums placed in a general optional guaranty reserve in C.E. 20 April 1959, No. 77,189.

Ordinary corporations are, as a rule, granted the right to claim a credit, against the amount of income tax due from them, for sums withheld at the source for dividends and interest. Under Article 220-4, CGI, the said tax benefit is not applicable to insurance companies.

For purposes of tax administration, foreign insurance companies doing business in France are treated in the same manner as French insurance companies. However, with respect to non-resident firms reinsuring French risks, there is slight access over their books. The said firms are required to report the amount of net premiums collected annually in France or related to risks located in the country.[304] On the basis of the results gathered from resident insurance companies insuring similar risks in France, the Administra-

tion annually publishes coefficients representing the portion of those premiums deemed equal to net income from French operations.[305] Nevertheless, if the Administration is able to determine actual income from the reinsurance of French risks, tax is levied on the same.[306]

In accordance with Articles 206-5 and 219 bis, CGI, mutual insurance companies are exempt from corporate tax on income from their principal activity (insurance) and are subject to corporation income tax on income from real property, farms and forests, and movable capital at the reduced rate of only 24%. However, to be entitled to the preferential tax treatment, the mutual company must not issue life insurance policies must not pay compensation to its managers or administrators, and must divide among its members the excess of the receipts over the expenses and required reserves.

UNITED STATES

As compared to France, domestic life insurance companies in the United States get better treatment in connection with the taxation of their receipts.

Life insurance companies are subject to the regular corporate tax on their total income, including underwriting income and capital gains as well as investment income. Their tax base is determined in three phases.

In phase one, taxable investment income includes net interests, and other forms of investment income, reduced by the proportion of taxable investment income needed to meet the requirement of policyholders' reserves. The reserve deduction is determined individually rather than on the basis of industry-wide percentage. Capital gains are taxable. However, earnings on qualified employee pension plans are specifically exempt from tax.[307]

Phase two includes one half of the amount by which the net gain from operations, after policyholders' dividends, exceeds the taxable investment income computed in phase one. The 50% reduction is made because of the presumed difficulty in establishing with certainty the annual income of life insurance companies due to the long-term nature of life insurance contracts.[308]

Phase three is an effort to reach the untaxed, or deferred portion of phase two income. Thus, income not previously taxed is added to the tax base of the company when it is distributed to shareholders. Since shareholder surplus includes both an untaxed and a taxed portion, it is important to distinguish as to any distribution between amounts which have been subjected to tax at the company level and amounts which have not been so subjected.[309] In this regard, the Tax Code provides that distributions

to shareholders shall be deemed to have been drawn first from taxed surplus, so that the deferral resulting under phase two is not necessarily ended by a tax when dividend distributions are made, if the amount distributed does not exceed the prior taxed portion.[310] Untaxed surplus may also be taxed if it is accumulated beyond certain limits relating to either the policyholders' reserves or gross premium.[311] Hence, in this manner, a tax may be imposed on undistributed surplus not included in phase two.

Mutual insurance companies in the United States do not get additional notable benefits as compared to other non-life insurance comapnies.[312] However, under Sections 821 to 826, 831 and 832, IRC, mutual companies with gross receipts up to $150,000 are exempt from tax, while companies with gross receipts of between $150,000 and $500,000 are given the option to be taxed on investment income only.

If a foreign life insurance company is carrying on business within the United States, special rules are applicable to it which are not applicable to other foreign corporations or other foreign insurance companies.[313] The source rules contained in Sections 861 to 862, IRC, applicable to foreign corporations, as previously discussed, do not apply to a foreign life insurance company. It is

taxed on its "United States business" as defined in the Insurance Act.[314]

With respect to non-life insurance companies, they are taxed in much the same manner as other non-insurance corporations depending upon whether they are domestic corporations, resident foreign corporations, and non-resident foreign corporations. However, non-life insurance comapnies are subject to special rules regarding the computation of income. As in the case of life insurance companies, they are taxed on their investment income, underwriting income, and capital gains.[315]

Foreign non-life insurance companies engaged in trade and business in the United States are taxed only on United States source income as determined by Sections 861 to 865, IRC.

PHILIPPINES

In the Philippines, the tax treatment of domestic life insurance companies is better than in the United States and France.

Under the Philippines Tax Code, domestic life insurance companies are subject to a flat tax rate of 8 3/4% or under rates for ordinary corporations, whichever results in higher taxes, on its "investment income".[316] "Investment income", as defined by law, is limited to interests, divi-

dends, rent, and income from any other business other than life insurance business.[317] Thus, the Bureau of Internal Revenue has ruled that the commission income of life insurance companies is not subject to ordinary tax.[318] However, it is subject to the capital gains tax in accordance with the provisions of Sections 34 and 35, NIRC, as discussied earlier.

Another important aspect is the provision allowing domestic life insurance companies to deduct from gross income the net additions, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts.[319] Nevertheless, to be entitled to the said deductions, the domestic life insurance company must agree to pay the tax imposed on ordinary corporations under Section 24 (a), NIRC.[320]

Resident foreign life insurance corporations are taxed in the same manner as domestic life insurance companies. However, their investment income is computed in accordance with Section 24 (c) (2) as follows: "For purposes of this paragraph, the 'net investment income from all sources within the Philippines' of a foreign life insurance company engaged in the life insurance business in the Philippines is that portion of its gross world investment income which

bears the same ratio to that income as their total Philippine reserve bears to their total world reserve, less that portion of their total world investment expenses which bears the same ratio to those expenses as their total investment income bears to their total world investment.

Non-resident life insurance companies are taxed as ordinary corporations at the rate of 35% of the gross income from all sources in the Philippines, including capital gains. However, reinsurance premiums are not included in computing income.[321]

Domestic non-life insurance companies are, subject to certain exceptions, treated as domestic life insurance companies for tax purposes. The exceptions relate to the tax rate and the computation of gross income.

Domestic non-life insurance companies are taxed at the ordinary corporate income tax rates.[322]

As to the deductibility of reserves, in the case of mutual fire and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses, said companies shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus such portion of the premium deposits as are retained by

the companies for purposes other than the payment of losses and expenses and reinsurance reserves.[323]

With respect to mutual marine insurance companies, it shall include in their return of gross income gross premiums collected and received by them less amounts paid for reinsurance, but shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon those amounts between the period of ascertainment and the payment thereof.[324]

Unlike the United States, in the Philippines, there is no tax exemption granted to small mutual insurance companies.

Non-resident foreign non-life insurance corporations are taxed on its income in the same manner as non-resident foreign corporations.

CANADA

Insurance companies in Canada are treated for tax purposes, more or less, in the same manner as those in France. There are no special income tax rates for resident insurance corporations. The rates applicable to ordinary resident corporations apply to resident insurance corporations.

Under Section 41(3), ITA, it is provided that, in lieu

of the foreign tax deduction ordinarily allowed to taxpayers, a resident life insurance corporation may deduct from Part I tax otherwise payable the lesser of i) the income tax paid by it to the government of a foreign coutnry, or ii) the Part I tax otherwise payable on the corporation's taxable income for the year received from that country computed in a prescribed manner. The mode of computation is prescribed under Section 2400 to 2402, Part XXIV of the Income Tax Regulations.

Resident corporations other than life insurance corporations are subject to the ordinary rules regarding the computation of taxable income in accordance with the provisions of Division C of Part I, ITA. However, the special rules contained in Section 74, ITA, for computing income are applicable to it.

With respect to resident mutual insurance companies, in Canada, there is authority to support the view that they do not earn income. It is based on the mutual principle and the doctrine that income must be beneficially received. However, Section 68A, ITA, makes no distinction between mutual and non-mutual corporations when it states that, for the purpose of computing the income from business of a non-life insurance corporation, the following rules should be applied: (a) all premiums and other amounts received

in respect of an insurance contract or arrangement are deemed to have been received by the corporation in the course of its business and; (b) this income will be computed in accordance with the rules applicable in computing the income from a business under Part I; and, (c) all income from the property vested in the corporation will be deemed to be income of the corporation.

Moreover, Section 74 in conjunction with Section 11(1)(m), ITA, enables non-life insurance companies, both mutual and non-mutual, to deduct, in computing their income the amount paid or credited to policyholders. The amount so paid or credited must be in connection with business from the year. It should be credited or paid within 12 months of the fiscal year by any of three ways, as follows: i) by paying it to the policyholders; ii) by applying it towards discharging the policyholder's premiums owing to the company; or iii) by crediting it to the accounts of policyholders so as to entitle them to payment on or before expiry or termination of the policy.

Furthermore, Section 85B (5), ITA, precludes a general deduction for reserves with respect to insurance but allows non-life insurance corporations in computing income from the insurance business in such amounts as are prescribed.

Non-resident life and non-life insurance corporations

are in a sense treated in a different manner because of Section 110B, ITA. Under Section 110B (1), a non-resident insurance corporation is subject to an additional tax equal to 15% of the amount by which its taxable income earned in Canada for the tax year exceeds a) the aggregate of the tax payable under Part I; b) income taxes payable by it to the government of a province to the extent that such taxes were not deductible under Part I in computing its income for the year from the business carried on by it in Canada; and, c) such amount as an allowance in respect of net increases in its capital investment in property in Canada as is allowed by regulation. However, the non-resident insurer can elect not to pay the additional tax by paying a tax equal to 15% of the amount it has elected to deduct under Section 110B (4), ITA. In accordance with said provision, the non-resident insurer is supposed to deduct in computing its Canadian investment fund as of the end of the immediately following taxation year, an amount not greater than the amount, if any, by which the amount of its Canadian investment fund as of the end of the year exceeds the amount, as determined for purposes of the relevant authority, of such of the insurer's liability as of the end of the year as may be reasonably regarded to have been incurred by it in the course of carrying on its insurance

business.

6. Receipts of Private Educational Institutions

FRANCE

In France, unless a private educational institution is by law specifically exempt from income taxation or classified as a charitable or welfare non-profit organization, it is subject to tax on its income as any other private corporation. If the exemption is by provision of law, there is no problem whatsoever. If an educational institution is expressly declared to be a charitable or welfare organization by administrative action, it will also be exempt from tax on its income. Nevertheless, it should be emphasized that under Articles 206-5 and 219 bis, CGI, a charitable or welfare organization is subject to the corporation income tax, at a reduced rate of 24%, on any income derived from real property, from the exploitation of farms or forests, or from securities, claims, and other forms of movable capital.

UNITED STATES

In the United States, private educational institutions are exempt from taxation on its income if the requirements mentioned under Section 501 (c) (3), IRC, are fulfilled. The Section provides that a corporation or foundation is exempt from tax if (1) it is organized and operated ex-

clusively for educational purposes; (2) no part of its earnings inures to the benefit of any private shareholder or individuals; (3) no substantial part of its activities consists in carrying on political propaganda or otherwise attempting to influence legislation; and, (4) it does not participate in a political campaign on behalf of a candidate for public office. The private educational institution shall be subject to tax on its income, depending on the type of taxpayer it is, if it fails to satisfy the requirements laid down in Section 501 (c) (3).

PHILIPPINES

In the Philippines, under Section 27 (3), NIRC, if a corporation or association is organized exlusively for educational purposes and no part of the net income of said association or corporation inures to the benefit of any stockholder or individual, it shall be exempt from income tax.

If the conditions provided for under Section 27 (e) are not met, the private educational institution is subject to tax on its income at the rate of only 10% in accordance with Section 24, NIRC.

CANADA

In Canada, under Section 62 (1) (e), ITA, a charitable organization is exempt from income tax if all resources

of it is devoted to charitable activities carried on by the organization itself and no part of its income is payable to, or is otherwise available for the personal benefit of, any proprietor, member or shareholder thereof.

Furthermore, Section 62(1) (i), ITA, provides that a club, society or association organized and operated exclusively for social welfare or for any purpose except profit is exempt from income tax if no part of the income of which is payable to or is otherwise available for the personal benefit of, any proprietor, member or shareholder thereof.

On the basis of the said provisions, if a private education institution in Canada is able to satisfy the requirements prescribed, it is exempt from income taxation. Otherwise, it would be subject to tax depending upon the type of taxpayer it is.

F. NET BUSINESS INCOME

FRANCE

In France, net or taxable business income is defined as the excess of gross income over the expenses incurred in acquiring or preserving the income in accordance with Articles 13-1 and 209, CGI. The French individual and corporate income tax is based on the concept of net income. In other words, the income tax rate is applied to business income after deducting from gross business income the

expenses incurred in acquiring or preserving the income.

UNITED STATES

As in France, the U.S. federal income tax is fundamentally a tax upon net income. In the case of business companies or firms, net income means gross income (gross receipts less cost of goods sold) reduced by the operating expenses incurred in earning the gross income. The expenses are allowed as deductions from gross income in accordance with Section 161, IRC, and will be discussed with certain applicable limitations later.

PHILIPPINES

As in France and the United States, in the Philippines, income taxation is based on net income. Under Section 28, NIRC, "net income" means the gross income computed under Section 29, NIRC, less the deductions allowed by Section 30, NIRC. Thus, the gross business income less the allowable deductions of the taxpayer is the taxable net income of the taxpayer on which shall be computed the graduated rates in Section 21, NIRC, in case of individuals. As to corporations, the difference between the gross income and the allowable deductions is the amount subject to the tax prescribed in Section 24, NIRC.

CANADA

In Canada, as in the United States, France, and the

Philippines, the basis of taxation is also the net income. Section 2(3), ITA, provides that the net or taxable income of a taxpayer for a taxation year is his income for the year minus the deductions permitted by Division C. Thus, net business income, in Canda, is gross business income minus the expenses necessary for producing or preserving or protecting the income.

III. DEDUCTIONS

A. DEDUCTIBILITY OF ITEMS DEPENDING UPON TAXPAYER

FRANCE

With respect to individuals, in France, a non-resident, as compared to a resident, whether a citizen or an alien, is also entitled to deduct expenses directly connected with the earning of actual income from French sources.[1] He is also entitled to a credit for sums withheld for actual income earned from French sources. Nevertheless, in no case may the credit be used to reduce his tax below 24% of his taxable income.[2] It should be noted, however, that as to presumed income (income conclusively imputed to have been earned due to the possession of certain external signs of wealth, such as cars, boats, servants, and horses), a non-resident is not entitled to any deduction or credit whatsoever.[3]

In connection with corporations, a foreign corporation as compared to a domestic corporation, is not entitled to any deduction except in the case of royalties which may be reduced by 20% for presumed expenses before the 24% rate is applied.[4] The tax on services, applicable to royalties at 8.5%, is also deducted before the 24% rate is applied.[5]

UNITED STATES

In the United States, with respect to individuals,

citizens and resident aliens are entitled to deduct the same items.[6] Non-resident aliens engaged in business in the United States are entitled to deduct, subject to certain limitations, contributions to charity and the production of income in the United States.[7] The non-resident alien engaged in business in the United States is also allowed a a tax credit for sums withheld at local sources upon proper substantiation.[8]

Regarding corporations, resident foreign corporations, as distinguished from domestic corporations, aside from the deductible charitable contributions under Section 170, IRC, are also entitled to deduct items connected with the production of income in the United States.[9] Subject to compliance with the requirement of substantiation, resident foreign corporations are also allowed tax credits on sums withheld at local sources.[10] Non-resident foreign corporations are not entitled to deductions.

PHILIPPINES

There is no difference whatsoever between the Philippines and the United States with respect to rules involing deductions as applied to various classes of individuals and corporate taxpayers.[11]

CANADA

As in France, both residents and non-residents, whether

citizens or aliens, may deduct expenses connected with the actual earning of income in Canada. However, non-residents are not entitled to deduct anything whatsoever with respect to the additional income tax at the flat rate of 15% under Section 106, ITA, in accordance with the provisions of Section 108, ITA.

As to resident or non-resident corporations, the deduction rules with respect to resident and non-resident individuals are applicable.

B. THE CONCEPT OF INCOME-CONNECTED DEDUCTIONS AND ITS LIMITATIONS

Basically, deductions could be classified into (1) personal deductions; and, (2) income-connected deductions.

Personal deductions are mostly available to individuals under specific statutory authority. These deductions do not represent expenses incurred in earning or protecting income. Since this thesis deals solely with the treatment of business income, the discussion will be limited to deductions connected with the acquisition or preservation of income derived from business.

FRANCE

In France, Articles 39-1-1° to 39-1-5°, CGI, expressly specifies several items as deductible. Nevertheless, the fact that an expense is not mentioned in the French Tax

Code does not prevent its deduction if the expense is otherwise proper. There is little problem in connection with the deductions expressly allowable under the CGI. These will be discussed later. The difficulty lies in what is left unsaid.

The first principle with respect to the deductibility of business expenses is that the taxpayer may deduct the expenses incurred by him in the acquisition or protection of the business income (depenses effectuees en vue de l'acquisition et de la conservation du revenu commercial).[12]

Under the above principle, the key factor in ascertaining whether or not certain expense items are deductible is the purpose of the outlay. It must be for the purpose of acquiring or preserving income.

With respect to outlays for the purpose of acquiring income, in order to qualify the expense as deductible, it is not necessary that, because of the expense, income be actually earned. The fact that the purpose of the outlay is to acquire income will suffice. Examples of expenses for the purpose of earning income are: salaries paid to employees, amounts expended to purchase or manufacture inventory, and advertisement expenses.

Expenditures for the purpose of preserving income are also deductible. The outlay must have as its main objec-

tive the preservation of the assets of the business enterprise sor the business itself. Examples of the said expenditures are: insurance expenses covering the assets of the business, legal fees paid in connection with a suit to determine the right of an entity to engage in a particular line of business, and expenses to restrict competition if the competitor is powerful enough to destroy the business of the taxpayer incurring the expenditure.

Profits distributed by corporations are, as a general rule, not deductible. The reason is that the distribution of profits does not constitute an outlay for the purpose of earning or preserving income.[13] There is, however, an exception to this rule relating to new shares which will be taken up later.

Moreover, due to the requirement that the business must be for the purpose of acquiring or preserving income, there is a general prohibition against the deduction of personal living expenses.[14] In R.M. 7,526, J.O. 28 January 1961, Deb. A.N., p. 96, no deduction was allowed for social security taxes paid in connection with the employment of household servants on the ground that the payments were personal expenses. Baby-sitting expenses incurred were also not also allowed as deductions in

R.M. 13,866, J.O. 27 April 1962, Deb. A.N., p. 809. In R.M. 14,727 J.O. 6 June 1962, Deb. A.N., p. 1497, the expenses incurred by a person in volunteer work as hospital administrator was denied deduction as being in the nature of personal expenses.

Another important doctrine is that an expense is deductible from business income only if incurred in the "interest of the firm" and "in connection with its operations."

In C.E. 25 May 1960, No. 48,078, the educational expenses for the son of an associate of a limited liability company was not considered as made in the "interest of the firm" and "in connection with its operation". As a consequence, deduction of the particular expense was denied.

Interest on a loan incurred to satisfy a personal obligation of a firm associate was also refused deduction in C.E. 2 May 1941, No. 67,729.

An allowance given to the widow of a former associate of a business concern for her to be able to rent an automobile was also deemed not deductible.[15]

Moreover, it has been held that a businessman may not take a tax deduction for rent to the extent that the business premises are used as his living quarters.[16]

Another fundamental principle refers to the non-deductibility of an outlay if the expense has as a counterpart the acquisition of an asset that "increases the net-worth shown on the balance sheet."[17] In other words, it is necessary to distinguish between a non-deductible capital expenditure and an expense incurred for the purpose of earning the business income.

An illustration of the rule is C.E. 23 March 1933, No. 23.759, where it was held that sums spent to acquire the goodwill of an enterprise are not deductible expenditures. The reason is that the goodwill is an asset that increases the net worth of the taxpayer.

In R.M. 4,441, J.O. 13 July 1929, Deb. Ch., p. 2532, it was also declared that no part of an annuity paid as compensation for the acquisition of an asset is deductible.

Amounts spent to acquire a new factory building would be another example of an expenditure for the acquisition of a capital asset. Hence, it is not deductible in the year of acquisition. However, the value of a factory building can be written off over its useful life through annual depreciation deductions.

"Accessory" expenses incurred in relation to the acquisition of a capital asset are treated as a portion of the cost of the asset only if the expenses increase its value. Normally, there is no such increase.[18] Hence, the expenses are deemed to be connected with the earning of business income and, thus, deductible. Examples of "accessory expenses are commissions paid to brokers or registration taxes. It should be noted that the taxpayer is given another alternative with respect to accessory expenses. If he so desires, the taxpayer could capitalize accessory expenses and write them off over a number of years as costs in the nature of organization.[19]

It must also be emphasized that an expenditure that has as its counterpart the reduction of a liability is not deductible.[20] An example would be the payment of the principal of a debt. In this regard, the reason given for disallowing deduction is the fact that the extinguishment of an obligation is something that increases the net worth of an enterprise. Nevertheless, it is submitted that, if the payment was made to settle an obligation incurred for the purpose of earning income, such as the purchase of goods for resale or the acquisition of raw materials for the production of a particular commercial product, the payment would certainly be a deductible expense.

Under Article 27 of the Act of July 12, 1965, business firms must accompany the declaration of their "results" with a detailed return of expenses when such expenses exceed limits laid down by Ministerial Order. The expenses in question come under four categories, as follows: i) expenses relating to highly paid persons in a firm; ii) expenses in connection with buildings not used for trading purposes; iii) presents, other than objects of small value specially designed for advertising purposes; and, iv) entertainment expenses.

If the business enterprise fails to make a return or files an incomplete return, the unsubstantiated expenses are automatically included in its taxable income.[21]

With respect to "sumptuary expenses", the deduction of expenditures regarding hunting, shooting and fishing; pleasure craft; and, amenity dwellings are expressly forbidden .[22]

As to the payment of compensation for services rendered, there is a requirement that the payment should be the normal remuneration for actual services performed. To the extent that the payment is abnormal in amount, deduction is not allowed. This will be discussed extensively later.

It should be underscored that in France, as in Canada, the principle of "normality of payments" or "reasonableness"

is not restricted to expenses involving compensation for services rendered.

Under Article 39-2, CGI, fines, penalties and other expenses resulting from the violation of laws regulating prices, rationing, and the assessment of taxes are expressly declared to be non-deductible.

In R.M. 7,734, J.O. 5 March 1958, Deb. C.R., p. 409, it was stated that fines paid by a trucking enterprise for the traffic violations of its drivers are not deductible. Furthermore, in C.E. 22 December 1944, Nos. 76,445 and 76,446, it was declared that if a fine is non-deductible, the legal and other fees arising out of the matter are generally non-deductible. However, penalties for the late payment of a deductible tax are sometimes deductible.[23]

Damages that a compnay firm is required to pay by order of a court are deductible if they are the result of normal business transactions. Thus, in R.M. 2,307, J.O. 1 March 1929, Deb. Ch., p. 745, the damages that a corporation paid as a consequence of an automobile accident involving its managing director, while on a business engagement were considered deductible. It should be noted that the fines arising from the accident were not adjudged deductible.

No express provision bars the deduction of illegal expenses. Thus, if "a business enterprise is required to

pay rent for business premises at a rate in excess of the legal ceiling, the total rent paid will ordinarily be deductible."[24] Another illustration is C.E. 23 December 1959, No. 40,578. In this case, due to the conditions of the time, the excess over the legal prices, paid by a firm to acquire goods on the black market during and after the occupation, were held deductible. However, deductibility is the exception rather than the general rule with respect to illegal expenses incurred in connection with an illegal activity.

Corollary to the rule that the income of foreign branches of French Corporations are not taxable, expenses incurred by such branches, except in certain situations to encourage French exports, cannot be deducted by French corporations.[25]

Finally, if the expenses incurred by a taxpayer relates partly only to business, solely, the part relating to business may be deducted.[26]

UNITED STATES

In the United States, Section 162 (a), IRC, provides for the deduction from gross income of the general expenses of a business concern. Pursuant to the said provision, "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are deductible.

The burden of clearly showing that the deduction falls under Section 162 (a) is on the taxpayer as explained in Interstate Transit Lines v. Commissioner.[27] The reason for the rule is that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.

There are other Sections of the U.S. Tax Code that specifically provide for the deduction of certain items, such as interest, taxes, losses, and bad debts. These deductions, even if not specifically enumerated, would presumably be allowed as deductions to business enterprises in accordance with the language of Section 162 (a).[28]

An expense, to be deductible from business income under Section 162 (a), must be "ordinary and necessary" in nature. The equivalent of this in France is the "firm's interest" and "in connection with the business" requirement.

The "ordinary and necessary" requirement is explained in Welch v. Helvering, as follows:

> "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make then often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

> ...The situation is unique in the life of an individual affected, but not in the life of the group, the community, of which he is a part."[29]

In the Welch case, a former officer of a bankrupt company entered into a similar business on his own account. In order to re-establish his relations with its customers and to improve his credit standing, he paid certain debts of the bankrupt company. Granting that the payments may have been "necessary" to the development of the taxpayer's business, the deductions were not allowed. The reason was simply because the payment of another's debts without any legal obligation to do so does not constitute "ordinary" conduct in the business community. Moreover, the Court seemed to have regarded the payment of the company's debts as analogous to the payment of a personal expense, thus implying that the action of the taxpayer was motivated by factors not directly or exclusively related with the pursuit of his business or trade.

Other examples of payments made which were adjudged as not constituting "ordinary" conduct in the business community are the following: 1) payment by a bank of a judgement against its president for mismanagement of trust funds;[30] 2) payment by a corporation to settle a litigation between the trustees of a trust which held its shares and the objectors to the accounting of the trustees;[31] and,

3) payment of an importer to creditors of its foreign supplier to save its source of supply by averting the bankruptcy of the supplier in question.[32]

However, a deduction was allowed where a medical partnership voluntarily made up the operating deficits of a non-profit hospital which it controlled[33]. The decision was based on the fact that ready access to hospital facilities was a factor in obtaining patients considering the shortage of hospital facilities. Hence, the payment was made to maintain existing business relationship rather than the creation of favorable conditions for the launching of a new business as was in the Welch case.

If the payment is for the purpose of maintaing existing goodwill and not an expense to acquire goodwill, as was the situation in the Welch case, it is considered as falling within the "ordinary" requirement. Thus, the amounts expended by a corporation to pay the personal debts of its deceased and insolvent president to salesmen which it employed in order to retain their loyalty were held to be deductible.[34]

As in France, in claiming deductions, the expenses must not only be actually paid or incurred but should also be substantiated by evidence of payment such as receipts or vouchers. Nevertheless, even if the taxpayer is unable to

support his claim with receipts, if the expenses are commonly made in the profession or business, his failure to keep an exact account of the expenses will not entirely deprive him of a deduction.

In Cohan v. Commissioner, [35] the taxpayer had to be free-handed in entertaining actor's employees and dramatic critics because of his business. He also spent a large sum travelling with his lawyer. The expenses amounted to a substantial sum but he was not able to substantiate with receipts his claim for deduction of the said expenses. The Court ruled that definitely "something was spent." Hence, to allow nothing was inconsistent. It pointed out that certainly, there was some basis of computation, and if necessary, the Board could draw upon its own personal estimates of the minimum of such expenses.

As to the expenses incurred as compensation for services rendered, there is also a requirement that the amount claimed should be reasonable. The counterpart of this requirement in France is the "normality of payments" test. This matter will be discussed later.

Another requirement in connection with the deductibility of expenses is that it should be expended in carrying on any trade or business. The counterpart of this, in France, is the "for the acquisition and protection of income" test.

The main difficulty arising, in this regard, is the problem of distinguishing between business expenses and personal living costs. Section 262, IRC, specifically prohibits the deduction of living expenses.

In numerous cases, the issue is factual. Is the claimed expense one which arose in a business setting or did it in fact arise from activities of an admittedly personal nature?[36] At times, the problem is, to a large extent, administrative. As an authority explains it, the question "involves, on the one hand, the honesty of the taxpayer in the filling out of his return, and, on the other, the limited capacity of the Service to audit that return and verify its contents."[37] However, in some cases, where the facts underlying the claimed expenses are known, the issue is, usually, one of theory: "is the activity giving rise to the expense ... one which should properly be regarded as business or as personal in character?"[38] Thus, the problem involves the drawing of a dividing line between the business and other profit-seeking activities of the taxpayer and those activities which are primarily devoted to the satisfaction of personal or family needs.[39]

The non-deductibility of personal and living expenses will be taken up in more detail later.

As in France, Section 263, IRC, specifically provides

that, in computing taxable income, no deduction shall be allowed for certain capital expenditures, including primarily" any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Moreover, under Section 167, it could be gathered by implication that, since capital expenditures could be depreciated, there can be no immediate deduction of the same.

It should be emphasized that the limitation with respect to the deductibility of capital expenditures is not totally dependent upon Sections 263 and 167.[40] Essentially, it is based on the interpretation given to the term "expenses" in Section 162(a). An outlay that is classified as a "capital expenditure" is not an "expense" deductible under the latter Section.

At times, it is difficult to distinguish between capital expenditures and ordinary expenses. If the outlay is in payment for an asset whose useful life exceeds one year, it is considered a capital expenditure.[41] Examples of capital expenditures are: cost of acquiring or constructing buildings, machinery, furniture, and fixtures; land costs including maps and surveys; amounts expended in defense of title to property; the cost of obtaining copyrights; commissions paid in purchasing securities or other property; and, the cost of

goodwill acquired in connection with the acquisition of the assets of a business.[42]

In the Mt. Morris Drive-In Theatre Co. case[43] the taxpayer was required to construct a drainage system in order to prevent water from draining onto the neighboring property in settlement of a lawsuit brought by an adjoining landowner. The need for a drainage system resulted from the improvements made by the taxpayer to adapt its land for use as a drive-in theatre. The Court held that the cost of the drainage system was a capital expenditure on the ground that it represented a permanent improvement to the taxpayer's property.

The Internal Revenue Service permits the deduction as a current expense of the cost of acquiring an item which is consumable within one year.[44] Moreover, the courts have allowed taxpayers to treat as current expense the cost of installations constructed to maintain the income-producing status of a property, even though the useful lives of the installations extend beyond a one-year period.[45]

The Courts have also imposed a limitation on the deductibility of business expenses relating to considerations of public policy. In accordance with the public policy requirement, in general, an expense deduction will be denied if allowance of the same would frustrate clearly defined

national or state policies proscribing particular types of conduct.[46]

In Harden Mortgage Loan Co. v. Commissioner, [47] payments to obtain political influence as an aid to securing government contracts were disallowed as deductions on the ground of public policy. However, in Lilly v. Commissioner,[48] the Supreme Court allowed the deduction of payments made by an optical firm to opticians who referred their patients to the firm. This practice, though not illegal, had been condemned on ethical grounds by the American Medical Association. The Court explained that the public policy limitation is applied only where the policy in question had been "evidenced by some governmental declaration", presumably in the form of legislation or administrative regulations. Here, there was no government declaration whatsoever.

Another interesting case is that of Kelly-Dempsy & Co.[49] Here, the expenses to induce the inspectors of a purchasing enterprise to accept the seller's product were held not deductible because to allow the same was violative of public policy.

Lobbying expenses are, as a general rule, not deductible.[50] However, there are exceptions to the rule. Expenses which may be deducted are: (1) expenses relating to appearance before and communications with a legislative body, committee,

or individual legislator; and, (2) expenses in connection with the communication of information between the taxpayer and an organization of which he is a member, even though such information is also made to legislators.[51] In either situation, the expenditure must qualify as an ordinary and necessary business expense.[52] No deduction is allowed for legislative expenses incurred for reasons not directly connected with the conduct of the taxpayer's business.[53]

Where the disbursement is itself illegal, although connected with the operation of a legitimate business enterprise, deduction has been denied for reasons of public policy. The most common example is that of a bribery payment to a public official.[54] In the Boyle, Flagg & Seaman, Inc. case,[55] payments by an insurance company to automobile dealers for sending it applicants for insurance were denied deduction. The said payments were a common occurrence in that state, although it violated a state statute.

As in France, where the over-all business activity is illegal, the courts usually draw a distinction between the common day to day expenses of the business and those which are required by and take their coloration from the illegal character of the business.[56] In Commissioner v. Sullivan,[57] the Supreme Court held that normally allowable expenses for rent and wages paid by the owner of an illegal book-

making enterprise are deductible in computing taxable income. With respect to legal expenses incurred in an unsuccessful defense of criminal proceedings, the same are not "ordinary and necessary" and, hence, are not deductible. However, in Commissioner v. Shapiro,[58] a deduction was allowed for legal expenses incurred in a successful defence of a criminal tax evasion charge. Legal fees disbursed in connection with civil proceedings involving charges of fraud or similar conduct were held to be deductible regardless of the outcome of the litigation.

As in France, the payment to a government of a fine or other monetary penalty is, generally, not allowed as a deduction.[59] The reason is the fact that the allowance of the deduction, by reducing the monetary cost to the violator, would frustrate the policy of the statute under which the fine or penalty is paid.[60]

There is, nevertheless, an exception with respect to violations of price regulations depending upon whether the violation was willful or innocent.[61] If the failure to comply with price controls was due to inadvertence, the law simply required the taxpayer to repay the amount of any overcharges to the government. In this situation, the courts have generally permitted the taxpayer to deduct the amount of the repayment because the deduction would not frustrate

the policy of the legislation imposing the penalty. Unlike the United States, it should be noted that, in France, there is a specific prohibition regarding the deductibility of expenses involving the violation of price laws.

PHILIPPINES

In the Philippines, allowable deductions from gross income in determining the net income are treated by the provisions of Section 30, NIRC.

A taxpayer seeking a deduction is required to point out an applicable statute and show that the deduction claimed falls within its terms. As in the United States, the reason is simply because the allowance of a deduction is a matter of legislative grace.

Section 30 (a), NIRC, states that for expenses to be deductible, the expenses must be "ordinary and necessary".

The two requisites of "ordinary" and "necessary" must go together.

To be "ordinary", the expense must have some reasonably proximate relation to the usual conduct of the business of the taxpayer. In this regard, Philippine courts have adopted the explanation of the U.S. Supreme Court in Welch v. Helvering.

The expense should also be "necessary". Visayan Cebu Terminal Co. Inc. v. Collector of Internal Revenue[62]

declares that an expense is considered "necessary" where the expenditure is proper or helpful in the development of the taxpayer's business or that the same is appropriate for the objective of realizing a profit or minimizing a loss. The "necessary" requirement is succinctly explained as follows: "Did the expenditure affect the earning capacity of the taxpayer by making him maintain the same or by making him produce or earn more through increased output or decrease in cost? If the answer is in the affirmative, then the expense is necessary; otherwise it is not deductible."[63]

Hence, the cost of constructing the logging roads incurred by a company in connection with its logging operations under its timber license and timber exploitation contract constitutes ordinary and necessary expense deductible from gross income in the year incurred.[64] "Tips" which a motel operator gives to taxi drivers and other persons for bringing in customers are also ordinary and necessary expenses incurred in carrying on the business and, as such, may be deducted from gross income for purposes of the income tax if properly substantiated.[65]

Another important requirement under Section 30 (a) is that the expense must be made or incurred in carrying on a trade or business. The expense must be a business expense to distinguish it from one that is entirely personal in

nature. It is difficult to determine whether a particular expense is personal or related to the taxpayer's trade or business. In numerous instances, the demarcation line where an expense leaves its personal character and becomes enmeshed in the taxpayer's business is thin and undefinable. In the ultimate analysis, what constitutes a business expense would depend upon the nature of the expense and the type of trade or business in which the taxpayer is involved. Nevertheless, it is safe to state, in this connection, that there is no difference in the United States and the Philippines with respect to the meaning of "personal expenses".

As in the United States and France, in the Philippines, capital outlays are not deductible from business income.

The problem lies in the determination of what constitutes business expense as distinguished from a capital expenditure. The rule is that "if an expenditure is made to attain an intended output, it is properly chargeable to capital as cost of development; if the expenditure is made to maintain an output, if is properly chargeable to operating expense. Where an expenditure covers both repairs deductible as business and capital items, it is incumbent on the taxpayer to make a proper segregation; otherwise the entire expenditure may be disallowed as a deduction."[66]

As in the United States and France, in accordance with

Section 30 (f), NIRC, the value of a capital asset, although not fully deductible in the year the cost for it was incurred, can be written off over its useful life through annual depreciation.

In the case of salaries or compensation for services actually rendered, as in the United States, in the Philippines, there is also a requirement that the amounts should be reasonable and, in fact, payments for services rendered. This matter will be discussed in detail later.

With respect to the deductibility of fines and penalties paid, the Lino Gutierrez case[67] is in point. Here, a deduction was claimed for fines and penalties paid resulting from the late payment of taxes. The deduction was not allowed. The Court explained that, while Section 30 of the Tax Code allows taxes to be deducted from gross income, it does not specifically allow fines and penalties to be so deducted. Moreover, it was pointed out that when acts are condemned by law and their commission is made punishable by fines and forfeitures, to allow them to be deducted from the wrongdoer's gross income, reduces, and so in part defeats, the prescribed punishment. In this regard, the Philippine rule is the same as those in the United States and France.

As to the deductibility of other disbursements against

public policy, lobbying expenses, and expenses where the over-all activity is illegal, Philippine courts will, in all probability, refer to American jurisprudence.

CANADA

In Canada, there are several basic tests to determine whether or not an outlay is a deductible business expense. They are: i) Was the expense incurred in accordance with the ordinary principles of commercial trading or accepted business practice? ii) Was the expense incurred for the purpose of gaining or producing income? iii) Was the expense not an outlay in respect of capital? iv) Was the expense reasonable?

Every expense item claimed as a deduction must be scrutinized in accordance with the said questions, and only if the answers to the same are all in the affirmative will the deduction be allowed.

With respect to the "business practice" test, Section 4, ITA, provides that, subject to the other provisions of Part I, the income for a taxation year from a business is the profit therefrom for the year.

Thus, the expense, to be deductible, must be connected with the business of the taxpayer in accordance with the ordinary principles of commercial trading and accepted business practice. The equivalent of this test is the

"interest of the firm" and "in connection with business" requirement in France and the "ordinary and necessary" test in the United States and the Philippines.

The "business practice" test is best understood by analysing cases dealing with what constitutes the commercial practice in a particular situation.

In the Royal Trust Co. case,[68] the appellant company claimed as deductions expenses for the membership fees and annual dues of certain officers of the company in various social clubs. The deductions sought were allowed because, among other reasons, the expenses incurred by the taxpayer were in accordance with ordinary principles of commercial trading or well accepted principles of business practice. The outlays made were consistent with good business practice in that they were incurred through a deliberate policy of promoting personal contacts which brought business to the company.

Another case on the "business practice" test is Sherritt Gordon Mines Ltd. v. M.N.R.[69] Here, the appellant mining company financed a project consisting of a mine, including a power plant, and an ore refinery through bond issues. The appellant agreed to pay, in addition to the normal bond interest, certain "commitment fees." The appellant claimed as deductions the amounts allocated as

"commitment fees". It was held that the appellant was entitled to deduct the portions of the "commitment fees" claimed as capital cost allowance and as exploration and development expenses, except for those parts of the latter which were allocated to the appellant's refinery. The commitment fees were not interest. Indeed the fees were clearly part of the cost of borrowing the capital required for creating property. The expense was in accordance with the generally accepted business and commercial principles at least where the amount was significant in relation to the taxpayer'r business, to capitalize payments of interest during the construction period because such interest became part of the capital cost of the property within Section 11 (1) (a), ITA. However, the development expenses allocated for the refinery was not considered deductible because they were incurred in searching for minerals within the meaning of Section 83A (2) and (3), ITA.

Section 12 (1) (a), ITA, provides that "an outlay for expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from ... business . . . " is not deductible gross income. Hence, as in France, U.S., and the Philippines, in Canada, to be deductible, the expense must be for the purpose of gaining or producing income from business.

Even up to now, there is still some confusion regarding the interpretation of Section 12 (1) (a).

There are those who believe that Section 12 (1) (a) in relation to Section 12 (1) (b) should be considered as positive provisions. The positive approach is based on the philosophy that the said statutory provisions set forth the deductions which may be taken. A direct result of the positive interpretation of the provisions equivalent to Section 12 (1) (a) and (b) under the Income War Tax Act was the birth of the so-called "income-earning process" test of deductibility. This test was laid down by the Supreme Court of Canada in M.N.R. v. Dominion Natural Gas Co. Ltd.[70] It reached full development in Montreal Coke and Manufacturing Co. v. M.N.R.[71]

Under the "income-earning process" test, it is not sufficient that the outlay be incurred "for the purpose of earning income". It is also required that the outlay must have been incurred as part of and immediately connected with, both in and time and result, with the trading aspects of the business operations. Pursuant to the said test, certain questionable conclusions were made by adherents of the positive view, as follows: 1) only expenses incurred by a person in his capacity as a trader, as compared to those made in the capacity of an owner, are

deductible;[72] 2) an expenditure regarding income that has already been earned is not deductible;[73] and, 3) an outlay to save an expense is not deductible.[74]

The main defect of the "income-earning process" test can be traced to the fact that it treats the "for the purpose of earning income" test, under Section 12 (1) (a), and the "capital outlay" test, under Section 12 (1) (b), as one and the same.

It is submitted that the better approach to the interpretation of Section 12 (1) (a) in connection with Section 12 (1) (b) is that the same are negative provisons.

The negative concept is based on the proposition that the provisions in question merely prohibit the deduction of certain outlays. They do not, either directly or by implication, permit any kind of deduction. Moreover, under the negative interpretation, the "purpose of earning income" test is considered as independent and distinct from the "capital outlay" test. This idea was aptly expressed in B.C. Electric Ry. Co. v. M.N.R.,[75] as follows: "... once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay."

It seems that the present sentiment of Canadian Courts is in favor of the negative approach.

Thus, in Rolland Paper Co. Ltd. v. M.N.R.,[76] the appellant company was charged with unlawfully conspiring with other companies to prevent or lessen competition in the manufacture and sale of fine papers. The company was adjudged guilty of the charge. It sought to deduct the legal expenses incurred as a result of the charge from its income. It was held that the legal expenses were deductible. The Court explained that the expenses were defrayed for the purpose of defending the appellant's trade practices and, until a final decision on the legality or illegality of the acts of the appellant was reached, the legal expenses were deductible under Section 12 (1) (a), ITA, as an expense incurred for the purpose of gaining or producing income.

The latest case on the matter is Olympia Floor & Wall Tile (Quebec) Ltd. v. M.N.R.[77] Here, the appellant company made substantial donations to Jewish charitable organizations and deducted the total as an expense incurred to earn income. The Minister, pursuant to Section 27 (1) (a), ITA, permitted the company to deduct charitable donations to the extent of 10% of its income and disallowed the deduction of the balance claimed. The company contended that the

donation had been made to create goodwill, to enhance the company's prestige in the Jewish community hoping that business contracts would go to the company from the private businesses of the officers of the organization. It was held that all the contributions made by the appellant that were over $100 were deductible in accordance with the provisions of Section 12 (1) (a) and the remainder were deductible as charitable contributions under Section 27 (1) (a). The Court reasoned out that the larger contributions made were expenditures laid out by the company largely, if not entirely, for the purpose of increasing or maintaining its sales and only subsidiarily, if at all, for charitable or benevolent reasons.

It should be noted that an outlay for the purpose of saving expenses was allowed in Bedford Overseas Ltd. v. M.N.R.[78]

The third test, as mentioned previously, is found in Section 12 (1) (b). It is similar to the rule on the non-deductibility of capital outlays in France, Philippines and the United States. The Section provides that no deduction shall be allowed with respect to an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion" except as expressly permitted by Part I of

the ITA.

It should be noted, however, that although the above items are not deductible immediately, a portion of the value of the assets are allowed to be depreciated annually, if the assets are depeciable in accordance with the Regulations, under a unique system to be discussed later.

The capital outlay test is succinctly expressed by Viscount Cave in British Insulated & Helsby Cables Ltd. v. Atherton,[79] as follows: "... when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstance leading to the opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

Due to the positive approach in interpreting Section 12 (1) (b) in relation to Section 12 (1) (a), the Dominion Natural Gas case came up with an exceedingly twisted version of the capital outlay test. From "bringing into existence of an asset or advantage", the test became "procuring the advantage of an enduring benefit" or even "preserving an asset or advantage". Under the twisted version, expense items, which were generally deductible under the classic

concept, could no longer be deducted.

The judicial authorities, perhaps, realizing the numerous absurd conclusions that would result from a strict application of the Dominion Natural Gas rule, gradually strayed away from it. Thus, in Kellog Co. of Canada Ltd. v. M.N.R.,[80] the Supreme Court modified the Dominion Natural Gas rule by providing that, if the asset preserved is a "free" asset of general use, the outlay in question would not be a capital one. In the Kellog Co. case, the appellant incurred certain legal expenses in connection with a suit against it for infringement of trademark in respect of "shredded wheat". The appellant claimed the legal expenses as deductions. It was held that, in computing income, legal expenses in the ordinary course of things are simply current expenditures and, thus, deductible. Stated otherwise, the legal expenses were laid out to maintain the trading and profit-making position enjoyed by the taxpayer in the "shredded wheat" business. Hence, the expenses were laid out to earn income and were properly deductible.

The Evans case[81] is also a departure from the rule laid down in the Dominion Natural Gas case. Here, the appellant spent on legal fees in an attempt to prove that she was entitled to an annual income of $12,000 for life in accordance with her father-in-law's will. The Minister

refused to allow the deduction of the legal expenses. It was held that the legal expenses were deductible. The appellant was never entitled to any part of the corpus or capital of the estate but only to the income arising from her share in the same. The payment of the legal fees did not bring any right, asset, or advantage into existence. Clearly, the appellant's claim, out of which the expenses arose, was with respect to income she believed she was entitled to and the legal expenses were properly incurred in order to obtain the payment of the income.

Of course, it should not be forgotten that it was in B.C. Ry. Co. Ltd., as discussed earlier, that the proponents of the negative concept really won a major victory. Since then, majority of the decisions declared that Section 12 (1) (b) should be considered as independent and distinct from Section 12 (1) (a).

Thus, in a case,[82] the expenses incurred to survey the mineral possibilities in an area where a railway company was operating in order to produce traffic for its transportation system was held to be deductible as having been made for the purpose of earning income and was not made with a view to bringing into existence an advantage for the enduring benefit of the business. In the same case, the Court also explained the meaning of "advantage". It is, according

to the Court, whatever may be acquired as an immediate consequence of the expenditure rather than the ultimate effect that is expected to flow into the taxpayer's business from what is acquired.

Generally, an expenditure for the acquisition or creation of a business entity for the purpose of earning profits is one on account of capital, but an expenditure in the process of operation of such profit-making entity is an expenditure on revenue account.[83]

The goodwill of a business is normally acquired on account of capital. However, goodwill can also be acquired as a by-product of operating a business. Thus, the legal expenses for the registration of a trade-mark, which forms part of the goodwill of a business, is money laid out on revenue account.[84] Outlays for legal services incurred in opposing U.S. income tax liability is not a capital item within Section 12 (1) (b), and, hence, deductible.[85] However, legal expenses to obtain, by statutory amendment, a tariff rate revision which resulted in the reduction of the cost of the materials that the taxpayer imported from the United States were considered outlays to secure an enduring benefit of a capital nature.[86] In this case, the legal expenses were treated as made to secure a benefit or advantage that was expected to be enjoyed over a long period of time

because of the principle that the Customs Tariff was a perpetual statute although it was subject to further amendment or repeal by a subsequent Act.

Taking into account the cumulative effect of recent decisions, there are those who maintain that the Dominion Natural Gas rule should no longer be considered as authoritative. Although this claim is, in a sense, correct, it should be remembered that, up to now, the Canadian Supreme Court has failed to officially declare the Dominion Natural Gas rule as dead. Moreover, in Farmer's Mutual Petroleum Ltd. v. M.N.R.,[87] wherein the legal expense was incurred for the purpose of opposing a proposed legislation, the outlay was held to be a non-deductible capital expenditure made with a view to preserving an asset or advantage for the enduring benefit of a trade in accordance with the Dominion Natural Gas rule. B.C. Power Corporation Ltd. v. M.N.R.[88] is another case which shows that the Dominion Natural Gas rule is still struggling for survival. In the said case, the legal expenses incurred, to preserve the appellant's title to shares, which constituted its principal capital asset, were also considered as non-deductible capital expenditures made in order to preserve an existing capital asset.

Section 12 (2), ITA, furthermore, prohibits the deduc-

tion of any expense, whatever be its nature, to the extent that it is unreasonable under the circumstances. In the Philippines and United States, a similar requirement also exists only in connection with payments relating to compensation for services rendered. In France, as discussed earlier, the requirement applies to payments other than compensation.

In determining whether or not an expense is reasonable under the circumstances, the question whether other taxpayers have adopted similar practices and made similar expenditures is important.

Thus, in Leigh v. M.N.R.,[89] a building contractor was disallowed the cost of his trips to Europe undertaken to acquire information about building methods, design, materials and processes and for its local advertising value. In deciding the case, emphasis was placed on the fact that other builders in the locality had not seen fit to visit Europe for similar purposes.

In ascertaining the reasonableness of a remuneration, the Court cannot substitute its own judgement as to what is reasonable but should consider only whether no reasonable businessman would have paid the compensation under the circumstances. By and large, the circumstances considered to determine the reasonableness of a remuneration

are: the functions exercised by the employee, the value of the employee to the company, the amount of time expended in connection with the work, and the comparative salary rates for similar positions in the same field of endeavor.

Hence, the compensation paid to an employee was adjudged reasonable, despite his record of academic failures, his being the brother of the company president, and the fact that his earnings for three months exceeded that of the Superintendent, because it was established that he was in fact the number two man in the company and the number two man normally received 70% of the most senior man's salary, he was the innovating driving force in the company, and he rendered better service than anyone in the company, including the Superintendent.[90] In another case,[91] the expenses for the salary of the wife of the company president was not allowed to be deducted in full because, although she worked full-time, was a faithful, responsible, and valuable officer of the company, it was unreasonable to set her salary at exactly the same rate as the husband who was the key figure and the prime mover in the company.

Under Section 12 (1) (d), ITA, the annual value of property is also specifically disallowed as a deduction.

Furthermore, under Section 12 (1) (e), an amount transferred or credited to a reserve, contingent account

or sinking fund, except as expressly permitted, is specifically disallowed as a deduction.

In accordance with the said provision, in North American Automobile Assn. Ltd. v. M.N.R.,[92] it was held that amounts set aside for estimated insurance are not deductible. The following are also not deductible: a) holdbacks from sub-contractors, subject to acceptance certification after completion of work;[93] b) improvements to leasehold property reserve;[94] c) payments or credits to sinking fund;[95] d) provision for market decline made by the underwriter of speculative shares;[96] e) refunds or defective materials reserve;[97] f) repairs and replacements reserve;[98] and, g) reserve for volume rebates.[99]

Amounts paid by an employer to a trustee under a deferred profit sharing plan or a profit sharing plan that is not i) an employee profit sharing plan, ii) a deferred profit sharing plan, or iii) a registered pension fund or plan, are also specifically disallowed as deduction.[100]

In addition, Section 12 (1) (h), ITA, provides that, in computing income, no deduction shall be made in respect of ... personal or living expenses of the taxpayer except travelling expenses (including the entire amount expended for meals and lodging) incurred by the taxpayer while away from home in the course of carrying on his business. An

identical prohibition is also found in France, U.S., and the Philippines.

Section 139 (1) (ae), ITA, gives an expanded meaning of "personal or living expenses". Under the said Section, "personal and living expenses include the following: a) the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit; b) the expenses, premiums or other costs of a policy of insurance, annuity contract or other like contract if the proceeds of the policy or contract are payable to or for the benefit of the taxpayer or a person connected with him by blood relationship, marriage or adoption; and c) expenses for properties maintained by a personal corporation, estate or trust for the benefit of the taxpayer as one of its shareholders or beneficiaries.

The following expenses were adjudged not deductible on the ground that they were "personal or living expenses": 1) cost of ordinary clothes used in business or occupation;[101] 2) expenses in connection with criminal proceedings and libel action against a partner;[102] 3) expenses of travelling to inspect income producing property;[103] 4) payment

of business debts of a relative,[104] and, 5) wages to domestic servants and baby-sitters.[105]

The exception to the non-deductibility of "personal and living expenses" is with respect to travelling expenses.

In Kejzlar v. M.N.R.,[106] under an oral agreement with a Toronto company, the appellant, an accountant without a recognized degree living in Toronto, made several trips by car to Philadelphia to perform certain services relating to the desire of the Toronto company to purchase the assets of a bankrupt company. The appellant claimed as deductions his living expenses in Philadelphia and the cost of travelling between Toronto and Philadelphia. His expense claim was unsupported by any statement or vouchers. The appellant was allowed to claim a deduction of $750 out of the $2,700 claimed. The evidence showed that the appellant was performing bookkeeping and accounting services for different clients and that the Toronto company did not have control over the manner he wanted to perform his services. The appellant was held to be self-employed and was clearly carrying on his business in Philadelphia. However, deduction was not allowed for the entire amount claimed because of his failure to produce sufficient vouchers to bear out his claim. Thus, it is clear that the requirement of substantiation also obtains in Canada.

The deductibility of travelling expenses will be discussed extensively later.

Section 12 (1) (c), ITA, states that no deduction shall also be allowed in respect of an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt. Section 139 (1) (o) defines "exempt income" as "property received or acquired by a person in such circumstances that it is, by reason of any provision in Part I, not included in computing his income and include amounts that are deductible under Section 28 or that would be so deductible if it were not for subsection (2) of Section 28."

In Distillers Corporation Seagrams Ltd. v. M.N.R.,[107] it was declared that administrative expenses apportionable between taxable and exempt income are computed on the basis of capital invested rather than on the ratio of the income. Debenture interests are also not deductible from the investment income of a mining company during the tax exempt period.[108]

It should be noted that, under Section 12 (6), ITA, Section 12 (1) (c) does not apply in respect of an outlay or expense made or incurred by a taxpayer, at a time when

more than 50% of its property consisted of property leased to a subsidiary controlled corporation subsidiary to it or shares in the capital stock of, bonds, debentures, mortgages, or hypothecs or of bills or notes of a subsidiary controlled corporation subsidiary to it, for the purpose of gaining or producing income in the form of dividends from any such corporation or in connection with property in the form of shares in the capital stock thereof. Pursuant to Section 139 (1) (aq), ITA, a "subsidiary wholly owned corporation" means a corporation all the issued share capital of which (except director's qualifying shares) belongs to the corporation to which it is subsidiary and "subsidiary controlled corporation" means a corporation more than 50% of the issued share capital of which (having full voting right under all circumstances) belongs to the corporation to which it is subsidiary.

Problems arise regarding the deductibility of expenditures that are laid out in breach of the law or pursuant to agreements somehow contrary to law.

In No. 690 v. M.N.R.,[109] gifts by an architect in the form of bribes to obtain contracts were declared not deductible in computing income. However, in Espie Printing Co. Ltd. v. M.N.R.,[110] a printing company carrying on an entirely legal business was allowed to deduct wages paid to its

employees under an illegal arrangement enabling the employees to avoid payment of income. The nature of the illegality was not clear. Nevertheless, the Court assumed that wartime regulations were violated and that there was some sort of arrangement to enable employees to avoid the payment of income tax. The Minister argued on the ground of public policy. The Exchequer Court rejected the public policy argument. It pointed out that profits from carrying on business in violation of the law were taxable and that if the policy of the law supported the taxability of illegal gain, it could not refuse the deductibility of illegal expenditure. In an earlier case,[111] the Supreme Court also decided favorably on the deductibility of illegal expenditures. Hence, it would seem that the rule in Canada, in this regard, is different from those in France, U.S. and the Philippines.

With respect to fines and penalties, the decisions lean more towards the non-deductibility of the same as in other countries which are the objects of this comparative analysis. Thus, in the King Grain and Seed Co. Ltd. v. M.N.R.,[112] a fine imposed upon a company for overloading one of its trucks travelling on a U.S. highway was disallowed as deduction since it was imposed as a punishment for a breach of the law. A fine imposed by a stock exchange for conduct

detrimental to the exchange was also not held deductible since it was imposed as a punishment.[113]

In C.I.R. v. Alexander von Glehn,[114] an English case, the amounts paid in settlement of penalties imposed for a breach of the Customs (War Powers) Act were held not to be losses connected with or arising out of trade. It was simply an incident which followed after the profit was earned. Hence, the payments were held to be non-deductible.

As to legal and other expenses arising from a suit, the cases pertaining to the question were already discussed earlier.

C. SPECIFIC DEDUCTION ITEMS

1. Initial and Operational Expenses

There are certain business expenses involving the existence and operation of an enterprise. For purposes of this thesis, the said disbursements are classified as "initial and operational expenses". The said expenses are the following: i) organization expenses; ii) compensation for services rendered; iii) rentals; iv) expenses for repairs and maintenance; v) insurance premium payments; vi) travel and entertainment expenses; vii) expenses for business gifts; viii) payments of fees; and, ix) expenses to restrict competition. These will be discussed in turn.

a. Organization Expenses

FRANCE

In France, frais de premier etablissment (organization expenses) include the costs of setting up a corporation, issuing bonds, and other similar transactions. In this regard, the business firm may opt to deduct said expenses in full in the year they were incurred or write them off over a number of years.[115] In case of write-off, it must be made immediately and not be abnormally deferred. Thus, in C.E. 9 March 1960, Nos. 36, 962 and 38,924, it was held that organization expenses incurred in 1933, which could have been deducted from profits in 1937, 1939, and 1946, could not be postponed until 1947, 1948, and 1949. Furthermore, under the French General Accounting Plan, the expenses in question should be written off in five years at most.[116]

Other items considered as organization expenses are lawyer's fees, commissions, registration taxes paid on the acquisition of business goodwill or a business building, costs of merger, and extraordinary advertising costs expended to establish a new trade-mark.[117] In C.E. 9 March 1960, No. 36,962, a new business concern was permitted to treat laboratory and market research costs as organization expenses that could be capitalized and written off over a number of years instead of deducting them in full during

the year the same was incurred.

UNITED STATES

In the United States, unlike France, there can be no full deduction of the organization expenses in the year they are incurred.

Under Section 248, IRC, a corporation may choose to treat its organizational expenditures as deferred expenses. Once the election is made, the expenditures may be amortized ratably over a period of not less than 60 months, beginning with the month in which the corporation commenced business. Otherwise, the expenditures would have to be capitalized.[118] Since a corporation, normally, is regarded as having perpetual life, these capitalized amounts would be deductible only when the corporation surrenders its corporate charter.[119]

In the United States, the term "organization expenditures" includes such items as fees paid to the state of incorporation and the expenses of legal and accounting services incident to the organization of the the corporation.

Section 248 does not apply to expenditures concerning the issuance of shares of stock, such as commissions and printing costs, or to expenditures connected with the reorganization of an existing corporation, unless a new corporation is formed. Moreover, the said Section applies only to corporate expenditures. Thus, the cost of organi-

zing a partnership or other entity remains a nondepreciable capital item.

PHILIPPINES

In the Philippines, except for the general provisions on expenses under Section 30 (a) (1), there is no specific provision in the NIRC regarding the deductibility of organization expenses. However, the rules, regarding the matter, obtaining in the United States, are similar to those in the Philippines. If organizational expenses are capitalized, the same are only deductible when the corporation is dissolved. Deductions cannot be allowed during the pre-operation stage because there is no gross income to deduct the same from.[120] The policy is to allow organizational expenses to be amortized over a reasonable length of time the corporation would exist but the reasonable period of time is based on the amount of organizational expenses before the firm attains its operating stage.[121] Thus, the Bureau of Internal Revenue had, in several occasions, allowed the amortization of organizational expenses for a period of 10 years.[122]

As an incentive, corporations and enterprises registered with the Board of Investments are, as a matter of right, allowed to deduct and amortize organization expenses within a period not exceeding 10 years depending upon the

choice of the enterprise.[123] The expenses include expenses paid to lawyers in the formation of the corporation, the expenses for the initial recruitment and training of personnel, and other similar costs.[124]

CANADA

In Canada, as in the United States and the Philippines, expenses incurred prior to the commencement of business operations are generally regarded as non-deductible either because they are laid out prior to the income-earning process or because they are connected with the capital structure of the business.

However, in McKee v. M.N.R.,[125] a non-resident businessman in partnership with a Canadian was engaged in an industrial development project. He maintained a separate office in New York. He travelled to Europe in an effort to attract foreign industry. The businessman also spent money because of his trips to Canada to deal with matters concerning the development project. The Appeal Board allowed the deduction of the organizational expenditures.

Moreover, the deduction of organizational expenses may be allowed if the business is formed for a single venture as opposed to a continuing business.[126] The depreciation of capital costs will be discussed later.

b) Compensation for Services rendered

FRANCE

In France, "compensation" includes salaries, allowances, director's fees, bonuses, and other similar payments made by an employer to an employee for services rendered.[127]

Wages and salariespaid by a business enterprise to its employees are generally deductible.[128] Wages and salaries are deductible regardless of the method of compensation or the manner of computation.[129] Payments may be made in cash or in kind and maybe fixed sums or sums paid in proportion to turnover or income.[130] Fringe benefits to employees and to board members and other executives of the firm for services rendered are also deductible.[131] However, distributions of percentage profits, unless for special services rendered, to members of the board of directors of a corporation are not deductible.[132]

In France, the right to deduct wages and salaries is subject to the restriction of normality of payment and the requirement that the name of the recipient must be disclosed to the tax administration.

Compensation for services is deductible only to the extent that the payment is a normal remuneration for the services actually performed.[133] Deduction will not be allowed to the extent that it is considered abnormal. In R.M. 439, J.O. 18 January 1963, Deb. A.N., p. 1075; C.E.

17 December 1956, No. 33, 161; and, C.E. 19 June 1959, No. 40,024, a stockbroker paid to his bookkeeper and a head clerk, in addition to small fixed salaries, a total of 2,500,000 Francs in 1951 and 2,100,000 Francs in 1952. The Tax Administration claimed that payments made in excess of 2,000,000 Francs were excessive and no longer deductible. The stockbroker contended that the employees performed heavy functions and that the compensation was not out of line as compared to the payments of other firms. Since the tax administration was not able to show the levels of compensation paid by other firms along the same line of business, the deductions claimed for salaries paid were allowed.

Unless the compensation appears to be grossly excessive, if the employee receiving the wage or salary payment is not an executive in the firm, a shareholder, or a relative of a shareholder, the normality of compensation is not ordinarily investigated meticulously.[134]

Aside from the level of compensation paid for similar services by comparable firms, normality of payment is also determined by the size, turnover, profitability of the employing firm, and the extent to which a person has contributed to the firm's success.[135] Hence, in C.E. 20 March 1959, No. 36,702, in a taxable year, the managing

director of a corporation had been paid 2,201,875 Francs as fixed compensation and 12,448.726 Francs as additional compensation at the rate of 3% of the gross income. The Council of State upheld the Tax Administration in denying the deduction to the extent of 4,000,000 Francs on the ground that the nature and volume of the sales of the corporation did not merit it.

Other factors for determining normality of payment are the total amount spent by the firm on management, the proportion of the executive's time spent on the firm's affairs, and the extent to which executives are paid expense or other allowances in addition to their pay proper. In C.E. 16, November 1959, No. 40,360, a limited liability company paid its managing director compensation of 4,756,000 Francs and a residence allowance of 450,000 Francs in one taxable year. The Council of State declared the residence allowance as a remuneration and approved the relatively high total deduction of 4,500,000 Francs because of the concentration of executive powers in the hands of the managing director involved. Another example is C.E. 7 May 1962, No. 51,849. In this case, the compensation of two executives were adjudged as normal considering that they alone operated the technical enterprise with 60 employees and that the firm enjoyed steady increase in sales and profits under their

management.

The other requirement in connection with compensation paid for services rendered as an item for deduction relates to the disclosure of the identity of the recipient of the payment. A business firm that pays remuneration of any kind is, under Article 240-1, CGI, and Article 47, CGI Ann., bound to disclose to the Tax Administration payments to any person other than an employee made yearly in excess of 5ó Francs per recipient. And, in accordance with Article 238, CGI, if the employer fails to make such disclosure, the payment may not be deducted in computing the employer's business income. With respect to a corporation, the effect of such a requirement is explained thiswise: "...[I]if the payor is a corporation, a payment to an undisclosed recipient ... is, in effect, subject to the corporation income tax in the payor's hands at the ordinary rate of 50%. In addition, the corporation is required to pay tax on such a payment at the highest rate of the individual income tax. The secret payment is also treated as a distribution of earnings and taxed as dividends; the payor owes the 24% tax ordinarily withheld at the source from dividend payments.... Like the secret payment itself, these penal taxes imposed on the corporation making the payment are not deductible. Thus, a corporation that made a secret payment of 1,000 F

in 1963 was required to pay a total tax of 2,525.5 F thereon, an effective rate of 252.55%, in addition to the corporation income tax at 50%, which was due on the payment because it was non-deductible."[136] The imposition of additional penalties as a result of the non-disclosure of the identity of the recipient is not done in the Philippines, Canada, and the United States.

UNITED STATES

There is no difference between the meaning of "compensation" in France and the United States.

Section 162 (a) (1), IRC, permits taxpayers to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." Thus, payments to employees in the form of salaries, wages, bonuses, and commissions, as well as the value of compensation paid in kind, are ordinarily deductible.

The deduction for compensation is limited to a "reasonable allowance". The Commissioner may exercise a broad discretion in disallowing salary payments which he deems to be excessive in amount.[137]

The problem of excessive compensation most often arises with respect to closely held corporations whose shareholders also draw salaries as employees. If such salary payments are found to be excessive, and the excess

is disallowed because it is really a guise for the distribution of profits, then the excess will be treated as a dividend to the shareholder-employee under Section 1.627 (b) (1) of the Regulations. Excessive salary payments are also disallowed when received by one who is a non-shareholder either because the excess represents a gift by the owner of the business to an employee who is also a member of the owner's family, and not an operating expense, or because, though neither a distribution of profits nor a gift, the payments are simply unreasonable in amount.[138]

Some of the principal factors which have been considered relevant by the courts in determining "reasonableness" are: (1) the nature of the employee's services and the responsibilities they entail, (2) the employee's skills and training, (3) the time required of the employee in the discharge of his duties, (4) rates of compensation paid by other employers for similar services, (5) whether the amount of compensation is contingent on the net profits of the business, and (6) whether there is a relationship between salaries and stock ownership.[139] Other factors may also be of importance, depending upon the circumstances of the case at bar.

PHILIPPINES

The meaning of "compensation" in the Philippines is

similar to that of France and the United States.

Under Section 30 (a), NIRC, the test of deductibility in the case of compensation payments is whether they are reasonable and are, in fact, payments purely for services. Whenever a controversy arises regarding the deductibility of certain items which are allegedly compensation of officers of the taxpayer, two (2) questions are material, namely: (a) have personal services been actually rendered by said officers? In the affirmative case ,(b) what is the 'reasonable allowance' therefore?

To determine whether the particular salary or compensation is reasonable, all available facts must be considered. In general, the employer is given a wide latitude of discretion with respect to salaries paid to the employees.[140] Nevertheless, where the question of reasonableness is an issue, the burden of maintaining reasonableness rests solely on the taxpayer.[141]

The most effective way to test the reasonableness of a salary payment is by comparing it with the amounts paid by similar establishments for the same kind of work.[142] However, in applying the test, the size of the business of the employer should be taken into account.[143] It is natural to expect that salaries would bear some relation to the size and complexities of the business of the employer

paying them.[144]

Other factors that are considered in determining the reasonableness of compensation are: (1) the qualifications of the employee; (ii) the extent and scope of the emplo - yee's work; and, (iii) the general economic conditions prevailing.[145]

Regarding whether the personal services have been actually rendered, the matter is purely a question of fact.

If the taxpayer is able to prove the reasonableness of the compensation paid on the basis of foregoing discussion, the payment will be considered as deductible.

CANADA

There is no difference with respect to the meaning of "compensation" in Canada, France, U.S., and the Philippines.

In Canada, payments for salaries, wages, commissions, and director's fees are also deductible subject to certain conditions hereunder discussed.

To be deductible, the salaries must have been paid in connection with the carrying out of a business. Thus, the salaries paid by a medical doctor to other physicians to assist him in handling plant medical work were held to be deductible.[146]

Bonuses paid to employees as additional wages are also

deductible.

Another requirement affecting the deductibility of salary payments is that it must have been expended for services actually rendered. In this regard, the so-called "salary" paid to the taxpayer's mother was held not deductible from his income derived from a partnership, in which the mother inherited her husbands share, because it was established that, she, in fact, performed no work for the partnership.[147] Fees paid to an absent company director were also adjudged as non-deductible.[148]

In accordance with Section 21 (2), ITA, salaries or wages paid to a spouse of the taxpayer are not deductible as business expenses. However, the said salaries or wages received are not taxable in the wife's hands. Salaries paid to children of a taxpayer are deductible when laid out for the purpose of earning the taxpayer's income and are reasonable in amount.

It should be noted that a commission or a bonus paid on the sale of a capital asset is considered as a payment on account of capital and not deductible.

With respect to bonuses or commissions paid in connection with the borrowing of money, the question of deductibility also depends upon whether or not the payments were made on account of capital.

As previously discussed, payments made on account of capital, unlike those expended for the purpose of earning income, are not deductible.

In this connection, the Silverman case[149] best illustrates the distinction between an expenditure on account of capital and a disbursement laid out for the purpose of earning income. Here, a mortgage loan was held by the Exchequer Court to be deductible from the income of a partnership dealing in real estate. It was established that the borrowed money was used to pay part of the purchase price of a residential property which had been quickly resold. Since the borrowed money did not add anything of a permanent nature to the assets employed in the business, the money so borrowed was not used as "capital" and, hence, the bonus was not a payment on account of capital.

Likewise, a commission paid to one company in return for assistance in securing additional capital for a third company was held to have been laid out for the purpose of earning income.[150]

Examples of payments considered as made on account of capital are the following: 1) commissions paid by a trustee for the purpose of securing mortgages;[151] and, 2) bonuses paid to a lender for obtaining or renewing a loan.[152]

The requirement of "reasonableness" was already discussed earlier. It is sufficient to state, in this regard, that the rules existing in the United States, France, and the Philippines are, more or less, similar to those found in Canada.

c.) Rent

FRANCE

In France, under Article 39-1-1°, CGI, rent paid for the use of real property in which a business is carried on is deductible.

For the above provision to apply, the real property must be owned by a person other than the taxpayer. No deduction may be taken for the rental value of property used by the owner in his business, even if rent appears as an expense in his books.[153]

However, in R.M. 6,968, J.O. 17 December 1960, Deb. A.N., p. 4731, it was ruled that if real property is used in a business by its owner, said owner may deduct depreciation and the actual expenses incurred in maintaining the property. He is also not required to include in income any presumed or imputed income arising from the use of the property.

Only rental payments considered as normal may be deducted. Thus, in C.E. 5 September 1944, No. 70,177, a com-

pany paid rental rates to another company with which it had a close community of interest abnormally above the comparative rental value of the building in question. The Council of State denied the deduction of the rent paid in excess of the actual rental value of the building.

If, in addition to rent, the taxpayer is required to give "Key Money" or similar sums, these amount may be deducted, generally, in equal installments over the life of the lease.[154] Furthermore, it was declared in C.E. 25 June 1951, No. 5,027, that a business tenant under the obligation to pay taxes, insurance premiums, and similar payments on behalf of the landlord may deduct the expenses as rental.

UNITED STATES

In the United States, as in France, Section 162 (a) (3), IRC, specifically provides for the deduction of "rentals or other payments required to be made as a condition to the continued use or possession, for the purpose of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Based on the above provision, it is clear that deductions would not be allowed if the owner of the property is the taxpayer himself.

Permanent improvements erected by a lessee on the

lessor's property are generally not regarded as rent but as capital expenditures whose cost may be recovered by the lessee through annual deductions for depreciation or amortization.[155]

The total premium paid by a lessee to obtain a long-term lease, as well as the amount of commissions, bonuses, or legal fees paid in securing the lease, is required to be capitalized and is deductible ratably over the lease term.[156] In comparison, an amount paid by a lessee for the cancellation of an onerous lease normally is deductible as a business expense in the year paid or accrued.[157]

In a case,[158] however, the taxpayer constructed an office building on leased property under a long-term lease and purchased the complete fee in the land and building for an amount in excess of the value of the land alone. The purchase was prompted by the taxpayer's belief that the annual rental obligation was too great. It was held that the taxpayer could not deduct as an expense for lease cancellation the excess of the purchase price over the value of the land, but was obliged, instead, to allocate such excess to the cost of the building and to recover that amount through allowances for depreciation over the building's remaining useful life.

Unlike France and Canada, the deduction for rentals

is not specifically limited by a standard of "reasonableness" in the United States. Nevertheless, it is required that payments which are characterized as "rent" be rent in fact and not merely a disguise for some other form of payment or distribution.[159] Hence, where the property was leased to a corporation, by its shareholders, at rentals found to be excessive, the excess payments were treated as dividends to the lessor-shareholders, and the corporation was not permitted to deduct such excess as rental expense.[160]

Rental deductions may also be challenged in the case of "gifts and leasebacks" between family members.[161] Indeed, a father may transfer business property to his minor child and then lease back the property at a fair annual rental. Under this situation, it is clear that, a deduction should not be allowed. Deduction of rental payments made was not allowed in a "gift-and-leaseback arrangement between a husband and a wife, on the ground that the donor of the property, the husband, had clearly retained control over its use and future disposition.[162] Nevertheless, gifts and leasebacks have been sustained where the property was transferred to a trust for the benefit of the donor's children, for the reason that the trustee was independent and not subject to the donor's control.[163]

If the taxpayer acquires equipment by an absolute or

conditional purchase, the sums paid to the vendor are considered as payments on the purchase price.[164] It can be recovered only through appropriate depreciation allowances over the useful life of the property.[165] On the other hand, rentals under an equipment lease are normally deductible when paid or accrued.[166]

If the lease is regarded as a lease in fact and not as a conditional sale, the lessee may in effect obtain the advantages of outright ownership and, at the same time, hasten the recovery of his cost through larger rental deductions.[167] Whether arrangements are to be treated as leases or as conditional sales is usually determined by analysing the basic intent of the parties in accordance with the facts and circumstances.

Factors which have been taken to indicate an intention to enter into a contract of conditional sale rather than lease are: (i) a provision vesting title to the equipment in the lessee at the termination of thelease or upon completion of a stipulated number of rental payments; (ii) a provision according the lessee an option to purchase the equipment at a price which is nominal in relation to the value of the property at the time when the option may be exercised; iii) a provision stating that the rental payments are to be applied against the purchase price of

the equipment; iv) a provision designating some part of the annual rentals as "interest"; and, (v) the fact that the annual rentals provided for in the agreement materially exceed the rental value of the equipment and the lessee is entitled to acquire the equipment for a nominal price on termination of the lease or to renew the lease for a nominal rental.[168]

PHILIPPINES

The authority for the deductibility of rental expenses is declared under the general provision on expenses found in Section 30 (a) (1), NIRC.

As in France, in the United States, and Canada, there is no doubt that rental expenses of a business are deductible under Philippine jurisdiction. This is, perhaps, the reason why there are no decided cases on the matter.

With respect to whether a transaction is a lease or some other contract, the varying legal consequences depending upon the true nature of the contract, the treatment of improvements constructed by the lessee on leased property, and other similar problems, there is no difference whatsoever between the rules in the United States and the Philippines. Even the revenue regulations are, to a large extent, similarly worded.

CANADA

As in France, the Philippines, and the United States, in Canada, Section 12 (1) (d), ITA, directs that, in computing the income of a taxpayer for a taxation year, no deduction shall be made in respect of the annual value of property except rent for property leased by the taxpayer for use in his business.

In Calgary & Edmonton Corp. Ltd. v. M.N.R.,[169] it was declared that the courts will look into the substance of contracts providing for rental payments to ascertain if they are in truth rental payments, or are merely part of the purchase price of the property, or represent a capital loss on resale of the property.

The rental value of a room used as an office in the taxpayer's own house is not a deductible expense.[170] However, where the office is part of the house or apartment rented by the taxpayer, a proportionate part of the rent equivalent to the amount disbursed for business purposes shall be considered as deductible.[171]

It should be noted that in Canada, the requirement of "reasonableness" applies to rental payments also.

d.) Repairs and Maintenance

FRANCE

In France, expenditures for the repair and maintenance

of equipments, machinery, buildings and other property are deductible. The said expenses should be distinguished from capital expenditures which are not deductible.

As a general rule, expenditures "made to maintain an asset in its normal operating condition as impaired by use or age are deductible."[172] On the other hand, expenditures that result "in an increase in the value of an asset on the firm's balance sheet" are not deductible.[173] Thus, installations of such major components as a new boiler or a new automobile engine were considered capital expenditure, and, as a consequence, deemed not deductible.[174]

Repair expenses are deductible whether or not the asset subjected to repair is owned by the firm.[175] In case of rented asset, the expense for repairs will only be deductible if the tenant is required by the lease contract or by ordinary practice to make the repairs.[176]

UNITED STATES

In the United States, Section 1.162-4, Regulations, provides: "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinarily efficient operating condition, may be deducted as an expense...." On the other hand, "repairs in the nature of replacements, to the extent that they ... appreciably prolong the life

of the property, must be capitalized and depreciated."[177] In this regard, there is no difference between the United States and France.

The usual problem in this area is how to distinguish between the cost of incidental repairs and maintenance, a deductible operating expense, and the cost of additions and improvements, a depreciable capital expenditure. The question is certainly one of fact.

As can be inferred from the cases, the principal criterion to be used in distinguishing between incidental repairs and capital additions is whether the work done appreciably extends the useful life of the property.[178] If so, it is regarded as a capital expenditure and is not deductible.[179]

The term "life of the property" refers to the property's expected useful life at the time of its original acquisition, not to its life expectancy at the time that the expenditure in question becomes necessary or advisable.[180] Thus, the cost of shoring up a building wall to prevent collapse of the building, have been held to be deductible as current business expenses where they neither added materially to the value of the building norappreciably prolonged its original useful life.[181]

Expenditures designed principally to maintain property

in good operating condition are deductible. In a case,[182] the taxpayer, a meat-packing concern, in order to avoid contamination of its products, expended certain sums to protect its premises against oil seepage caused by a neighboring refinery. The Commissioner contended that the expenditure was a capital improvement which had prolonged the useful life of the taxpayer's property. The contention was rejected. The Court found that the expenditure had been made not to enlarge the taxpayer's premises or to adapt them to a new use, but merely to enable the taxpayer to continue its business operations as it had done prior to the contamination threat. The expenditure was therefore deductible as a current operating expense. The same general test have been employed by the courts in other cases.[183]

Moreover, expenditures involving the replacement of minor parts or features of a larger unit are normally allowed as current deductions. Hence, amounts expended for repainting a building, replastering walls, mending leaks in a roof, repairing damaged vehicles, and replacing worn-out machine parts, have been held currently deductible.[184]

The cost of replacing a minor portion in a structure, or of reconstructing or renovating a capital asset in order to restore it to its original condition, is generally regarded as a capital expenditure, where the effect is to

prolong the life of the property or to increase its value in the hands of the taxpayer. In this connection, taxpayers have been required to capitalize the cost of replacing drainage equipment, of replacing an electrical system, of restoring building foundations, of replacing walls, doors, and floors, and of installing a new roof.[185]

PHILIPPINES

As in the United States and France, in the Philippines, under Section 68, Revenue Regulations No. 2, the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditure. It also directs, in accordance with Section 31(2), and (3), NIRC, that repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property should be charged against the depreciation reserve if such account is kept.

In deciding whether an expenditure is a capital one or is chargeable against operating income, it is important to note the purpose for which the expenditure was made.[186] To repair is to restore to a sound state or to mend. A replacement connotes a substitution.[187] A repair is an

expenditure for the purpose of keeping the property in an ordinarily efficient operating condition.[188] It does not add to the value of the property in an operating condition over its probably useful life for the uses for which it was acquired.[189] Expenditures for this purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use.[190] One is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.[191]

The expenses chargeable to earnings include the general expenses of keeping up the organization of the company, and all expenses incurred in operating the works and keeping them in good condition and repair; while expenses chargeable to capital include those which are incurred in the original construction of the works, and in the subsequent enlargement and improvement thereof.[192]

In Alhambra Cigars v. Collector of Internal Revenue,[193] there was an original construction of a hollow block fence with iron grills around the compound occupied by petitioner. It was held that the amount in question did not merely involve the cost of incidental repairs for the purpose of keeping the property of the corporation in an ordinarily

efficient operating condition. It was an addition which prolonged the life of such property and which materially increased its value. It was not just a maintenance charge or an expense of keeping up the business of the petitioner. Therefore, the disbursements amounting to ₱19,931.05 were considered capital expenditures which should not be applied against current earnings.

In another case, it was declared that the electrical supplies, paint, lumber, plumbing, cement, tiles, gravel, masonry and labor used to repair the taxpayer's rental apartments, did not increase the value of the apartments or prolong their lives. They merely kept the apartments in an ordinary operating condition. Hence, the expenses incurred were deductible as necessary expenditures for the maintenance of the taxpayer's business.[194]

CANADA

In Canada, as in France, U.S., and the Philippines, expenses for repairs are deductible as distinguished from replacement of capital assets which must be depreciated.

The existence of a Canadian legislative scheme of capital cost allowance, providing for the apportionment of capital costs over the estimated life of business assets with safeguards against deductions in excess of actual cost, is a valid reason for the disallowance of

abnormal repair costs in relation to assets covered by the scheme.[195]

As in the other countries subjected to comparative analysis, the alternative is not between allowance and disallowance but between immediate and deferred allowance. As aptly stated in the Haddon Hall case,[196] the issue is "whether such expenditures were an income expense incurred to earn the income of the year ... and allowable as a deduction from gross income in that year under sec. 12 (1) (a) of the Income Tax Act, or a capital outlay to be amortized or written off over a period of years under the capital cost allowance regulations made under Sec. 11(1)(a) of the said Act."

The problem relates to the determination of what constitutes an expenditure for the repair of an asset as distinguished from a replacement outlay.

There is authority supporting the view that, if the disbursement increases the value of the asset being repaired, the outlay is of a capital nature.[197] Pursuant to this view, the cost of renewing the roof of an old warehouse was classified as a capital expenditure because "the market value of the building has been increased proportionately to the value of the cost of reroofing".[198] Expenses for the improvements made by the lessee to meet the

requirements of the tenant in accordance with the lease contract were also declared to be capital outlays because they were not current expenditures made in the ordinary course of the lessee's business operations to earn income.[199]

If the repairs are recurrent in nature and the same are made in connection with the business operations of the taxpayer, the expenses arising therefrom are immediately deductible. Thus, where the vessels repaired were still used in the taxpayer's business following the completion of the repairs and before the same were delivered to the purchases, it was held that the outlays for the repairs were deductible business expenses.[200] However, the repair expenses would not be deductible if the vessels were no longer used in the taxpayer's business after completion of the repairs and that the agreements for their sale had been entered into at the time they were repaired.[201]

It should be noted that, once it is determined that the repair expenses are of a revenue character, the fact that the repairs have been allowed to accumulate and, therefore, increase their size and cost when finally undertaken, would not affect their classification as a revenue expenditure.[202]

e.) Insurance Premiums

FRANCE

In France, premiums paid by a business enterprise for insurance against casualties are deductible.[203] Examples of insurance against casualties are those for fire, flood, theft, windstorm, credit losses, and liabilities to third persons arising out of automobile, industrial, or other accidents.[204]

Premiums paid in group insurance policies for the benefit of a company's employees, or for a specific group of employees, are also deductible.[205]

With respect to insurance premiums paid by a company on the life insurance policy of an employee, the question of deductibility depends on whether or not the company is the beneficiary. If the proceeds of the insurance is payable to the company, the premiums paid on the subject insurance are not deductible.[206] However, if the proceeds of the life insurance are payable to the insured employee or a third person, the premium disbursements made by the firm could be deducted if the said disbursements may be regarded as supplemental wage payments.[207]

The above rule is, nevertheless, affected by the operation of the principle of normality regarding the salary or wages paid to an employee. Thus, in C.E. 23 December 1949, No. 98.621, a firm paid the premiums on the

life insurance policies of the son and daughter-in-law of its managing director. The total compensation, including the amount of premiums, paid to the son and daughter-in-law exceeded normal limits. The Council of State disallowed the deduction of the premiums.

UNITED STATES

As in France, insurance premiums are deductible if incurred in connection with the taxpayer's trade or business. Thus, under Sections 1.162-1 and 1.162-10 of the Regulations, deduction is allowed for the cost of insurance against fire, storm, theft, accident, and similar losses to business property, or liability insurance, workmen's conpensation, and fidelity bonds. The cost of insurance on non-business property, such as liability insurance on an automobile used for personal purposes, is not deductible.

As to life insurance, the rule is also similar to France. An employer may deduct premiums paid on the life of an employee only if the insurance proceeds are finally payable to the employee's estate or heirs, so that the premiums, in effect, represent a salary supplement.[208] If the proceeds are payable to the employer, deduction for premium payments is specifically denied by Section 264, IRC. Premiums paid by an employer on policies of group term life insurance covering the lives of his employees

and premiums on medical, hospitalization, and disability insurance maintained for the benefit of employees are deductible, even though such payments are not, in general, treated as additional compensation to the employees.[209]

PHILIPPINES

In the Philippines, the deductibility of insurance premiums paid by a business enterprise is authorized under the general provisions on expenses appearing in Section 30(a) (1), NIRC.

As in the United States, there is no doubt that insurance premiums paid on property used in trade or business are deductible.

Premiums paid by an employer on the individual life insurance policies of his employees, the family of the insured being the designated beneficiary, whether such designation is revocable or irrevocable are, for purposes of the income tax, deductible as business expenses. However, the payments must qualify as ordinary and necessary expenses in carrying on the trade or business of the employer. Moreover, it must not, directly or indirectly, be a beneficiary under the life insurance policies. Under Section 31 (4) , NIRC, it is specifically provided that where the employer has been irrevocably designated beneficiary in the policy of insurance taken out by the emplo-

yee, premiums paid on the insurance by the latter are not deductible for purposes of the income tax.

In a family corporation where the beneficiaries named in the policies are the members of the family who are also stockholders of the corporation, the premiums paid by the latter for such insurance are not deductible, the corporation being in such case the indirect beneficiary under the policies.[210]

Premiums paid by a partnership for a policy covering the life of its managing partner and where the partnership is the beneficiary under such policy, are also not deductible from the gross income of such partnership.[211]

CANADA

In Canada, in general all ordinary commercial insurance premiums are deductible. Hence, premiums paid for fire insurance on plant and machinery used in the business and insurance for use and occupancy or loss of profits are deductible. The determining factor is "what is the nature of the loss being insured against?"[212] If it is a revenue expenditure, it is deductible.[213]

However, in Hudson v. M.N.R.,[214] where a taxpayer sought to deduct the insurance premiums on the premises of a drive-in theatre purchased and held by him to lessen competition in his theatre business, the deduction was

disallowed. In this case, the expenses were clearly capital in nature.

It should be noted that, in Canada, unlike the Philippines, France, and the United States, no deductions are allowed with respect to insurance premiums paid on the life of employees except where the insurance policy takes the nature of a retirement savings plan.

f.) Travel and Entertainment

FRANCE

In France, Article 39-3, CGI, provides that general allowances paid to managers and executives of business firms to cover the costs of entertainment and travel are not dedutible if the firm's other deductions habitually include reimbursement for specific expenses of the same nature.

It should be noted that the provision is applicable only to managers and executives. Less important white-collar employees are not considered as executives.[215] Furthermore, the bar to the grant of a general allowance subject to reimbursement refer only to expenses "attributable to the executive" and not to those "attributable to the employer".

In general, an expense is considered as "attributable to the employer" when "it is incurred in the name of the

employer and relating directly to management."[216] An example would be the cost of entertaining a foreign visitor at one of the firm's plants.[217] The expense is attributable to the employee "if it is of a kind which, although incurred because of the nature of the functions the employee exercises, may not be regarded as incurred for the account and at the order of the employer."[218] An illustration of this is where expenses are made to entertain executives of other firms to maintain the employee's personal connections.[219]

There is also the rule that "if contact with and entertainment of customers is appart of the normal duties of an executive, the costs should be treated as attributable to him in the first place, not to the employer."[220] Thus, in R.M. 4,666. J.O. 3 March 1954, Deb. C.R., p. 290, expenses incurred by two directors of a firm in a tour of inspection of branches, involving dinners and similar items for branch managers and important customers, were considered as attributable to the directors and not to the firm.

It should be emphasized that if the business firm pays an executive a general allowance and reimburses him for specific expenses, it is the former that is disallowed as deduction.[221] The disallowed amount is deemed to be additional salary on which the employer's payroll tax is due.[22] Moreover, if the executives total salary, in-

cluding the disallowed expense allowance, exceeds the normal level, deduction of the excess is disallowed under the rules pertaining to salaries and wages.[223]

A firm that chooses to reimburse an executive on the basis of specific expenditures is "not precluded from making a reasonable estimate of those expenditures if they are of a nature whose existence is certain, but whose amount it is difficult as a practical matter to establish exactly."[224] Thus, in R.M. 5,028, J.O. 1 June 1960, Deb. A.N., p. 1098, it was declared that an employee who is reimbursed for his actual expenses may estimate the cost of meals provided that a record is kept of the exact number of days of travel and the estimate does not appeal excessive.

The non-deductibility of sumptuary expenses was already discussed earlier.

With respect to travel expenses, the expenses of an executive or an employee must be incurred for the direct account of the enterprise or those falling on the employee as a result of his duties.

In the instances above mentioned, the enterprise has an option either to pay the employee a general allowance or to reimburse him for actual expenses.[225] In either case, the expense will be deductible. However, the rule on "non-

accumulation" prevents the utilization of both alternatives with respect to one and the same travel expense.[226]

Where the company car is placed at the disposal of an executive or an employee, the problem is treated as if the executive or employee has been granted a travel allowance.[227] In C.E. 26 February, 1962, No. 50,289, it was held that to the extent that a company car was used by an executive for his personal affairs despite the argument that the use did not increase expenses borne by the company, deduction by the company of car expenses was denied.

UNITED STATES

As in France, in the United States, under Section 162 (a)(2), IRC, specifically allows a deduction for "travelling expenses including amounts expended for meals and lodgings other than amounts which are lavish or extravagant under the circumstances while away from home in the pursuit of a trade or business." This is an exception to the general rule under Section 262, IRC, which expressly prohibits the deduction of "personal, living and family expenses." The problem that commonly arises is whether, in a given case, the costs of transportation and of meals and lodging qualify as deductible business expenses, despite the normally personal character of these items.

In the Flowers case, [228] the Supreme Court declared that the appropriate test is whether the travel expenditures had been motivated by the "exigencies of the business" or by considerations of personal preference. If the expenses are of a personal nature and were incurred by the taxpayer for his own convenience rather than in the pursuit of a trade or business, the deduction of the same will be disallowed.

In the application of the "exigency of the business" test, the cases place the "tax home" not at the location of the taxpayer's home or residence in the usual sense, but at his place of business activity. Thus, a timber cutter, required to travel 20 to 30 miles each day in order to reach various logging sites located within the same general working area, was not permitted to deduct the cost of transportation between his home and place of employment.[229] The same rule applies to taxpayers having no permanent place of business.[230] An example would be a travelling salesman who maintains no home but merely lives in hotels in various cities.

However, an employee's travel expense will be allowed as a deduction if incurred in conjunction with a "temporary employment" activity away from the taxpayer's regular business location.[231]

Under this situation, the taxpayer is considered to be travelling away from home if, at the time of his employment at a new duty station begins, its termination within a reasonably short period of time is forseeable.[232] Hence, if the taxpayer is away from home because he accepted a job for an indefinite duration in another place, his travelling expenses are not deductible.[233] Nevertheless, in Harvey v. Commissioner,[234] it was declared that the Court would regard an employment as "temporary" where the facts showed that there was no reasonable probability known to the taxpayer that his new employment would be for an indefinite period. Indeed, it would be unreasonable to expect the taxpayer to move his permanent abode even though his employment is indefinite in the sense that the termination could not be predictedwithin a fixed period.

Under Section 1.162-1(a) of the Regulations, the cost of transportation within a local area from one business location to another - as, for example, automobile expenses incurred by a salesman in calling on a series of customers - is allowed. Moreover, if the employee is reimbursed by his new employer, the reimbursement will be included in his gross income.

As in France, entertainment expenses are, subject to certain conditions, deductible in the United States. If

the taxpayer can establish that the entertainment expenditure is germane; if not vital, to the routine conduct of his trade or business, the conditions of Section 162(a) are met.

The taxpayer must, thus, hurdle two statutory barriers. He must first establish that the travel or entertainment expense is deductible under Section 162, IRC, as an ordinary and necessary expense for the production of income or the management of income-producing property. He must also show that the provisions of section 274, IRC, including the requirement of substantiation, do not operate to disallow the deduction.

Section 274(a) denies deduction for the cost of "entertainment, amusement, or recreation" unless (1) the entertainment activities are "directly related to ... the active conduct" of the taxpayer's business, or (2) they directly precede or follow "a substantial and bona fide business discussion" (including convention meetings) and are "associated with" the active conduct of the taxpayer's business.

Entertainment activities include going to night clubs, theatres, and restaurants, as well as furnishing food and drinks, hotel suites, automobiles, and other facilities to business guests.[235] Section 274 applies to any expense

which is of a type normally considered to be entertainment. It applies even though the expense might also be described as belonging to other categories of deductible items, such as advertising promotion or public relations.

Section 274 also denies deduction for costs incurred with respect to an entertainment facility, unless the facility was used "primarily for the furtherance of" the taxpayer's business. The deduction allowed is only to the extent that the costs were directly related to the conduct of the business. Costs relating to an entertainment facility include rent, maintenance, depreciation, and losses with respect to such facilities as yachts, swimming pools, hotel suites, and hunting lodges.[236] Club dues are specifically treated as costs relating to an entertainment facility. If a facility is used mainly, but not solely, in the taxpayer's business, the expenses and depreciation which relate to it must be allocated between the business and the non-business use.[237] No portion of such costs is deductible if the facility is not used primarily for business purposes, even though it is so used from time to time.[238]

Another important requirement is that of substantiation under Section 274(d), ITC. To justify a deduction, the taxpayer must provide "adequate records," showing how much was spent on entertainment; when and where the expen-

diture was made; and, what the relationship was between the expenditure and the taxpayer's business. If the taxpayer claims a deduction for entertaining others, the identity and business relationship to the taxpayer of the persons entertained must be disclosed.[239]

The application of Section 274(d), in the case of employees receiving expense allowances or reimbursements from their employer, is set forth in the Regulations. Amounts received by an employee as reimbursement for travel and entertainment expenses incurred in connection with the performance of his duties are initially included in the employee's gross income, but can then be deducted by him in computing his adjusted gross income.[240] The Regulations, however, provide that an employee need not report in his income tax return travel and entertainment expenses incurred on behalf of his employer if the employee is required to, and does, "adequately account" for the expenses to his employer, and if the reimbursement exactly equals the amount of the expenses.[241] If total reimbursements exceed expenses, then, of course, the excess must be included in the employee's gross income.

Under Section 1.274-5(e)(4) of the Regulations, an "adequate accounting" for this purpose means "the submission to the employer of an account book, diary, statement of

expense, or similar record maintained by the employee in which the information as to each element of an expenditure ... is recorded at or near the time of the expenditure, together with supporting documentary evidence, in a manner which conforms to all the 'adequate records' requirements"previously described.

PHILIPPINES

In the Philippines, the basis for the deductibility of travel and entertainment expenses is Section 30(a)(1),NIRC.

Entertainment expenses may be deducted from the gross income if it can be shown that such are ordinary and necessary in the promotion of the business of the taxpayer. On this point, the Court of Tax Appeals declared:

> ".... It has become a business, and to a certain extent a professional practice to entertain actual or prospective customers or clients. Since expenses of this nature generally consist of a mixture of personal and business purposes, whether or not such expenditures will be allowed will depend upon the factor of the necessity of such expenses to earn the income or, that direct business benefits would be derived from such expenditures, or whether the expenses have some definite reasonable purposes connected with the business in hand and reasonably calculated to accomplish the end sought. In these instances, the burden of proof is on the taxpayer to show that such expenditures were primarily business rather than personal expenses."[242]

Under Section 30(a)(1), in the case of an individual, ordinary and necessary entertainment expenses in an amount not in excess of one thousand pesos or five per centum of

gross income, whichever is lesser, shall be allowed as deduction. In excess of the said allowance, claims for deductions must be substantiated, when required by the Commissioner of Internal Revenue, by record showing in detail the amount and nature of the expense incurred.

In Visayan Cebu Terminal Co., Inc. vs. Collector of Internal Revenue,[243] the Supreme Court stated that the Tax Court correctly ruled that the representation expenses fall within the category of business expenses which are allowable deductions only if they meet the conditions prescribed by law. The alleged representation expenses never had any supporting papers. The vouchers and chits covering the same have not been presented. There was no testimonial evidence introduced on any specific item of the expenses. While the gross income in 1950 exceeded the gross income in 1951 and 1952, the representation expenses for that year was only ₱10,000. The representation expenses in 1948 amounted to only ₱500. The company never tried to show why its representation expenses in 1951 should be deemed bigger than the amount allowed by the lower court. In fact, the latter had been liberal in allowing the company to deduct ₱10,000 as representation expenses for 1951, there being no concrete evidence of the sum then actually spent for purposes of representation. The explanation that the

supporting papers of some of the expenses had been destroyed when the house of the treasurer was burned, can hardly be regarded as satisfactory. The records of business firms are supposed to be kept in its offices, not in the residence of one of its officers.

Travelling expenses, which include expenses for transportation, meals and lodging, are obviously deductible if they are reasonable and necessary.

Under Section 66, Revenue Regulations No. 2, the following travelling expenses are considered to be reasonable and necessary: (a) When an individual, whose business requires him to travel, receives a salary as full compensation for his services and is not reimbursed for travelling expense allowance, his travelling expenses are deductible from gross income. (b) When an individual receives a salary and is reimbursed his actual travelling expenses, the amount so reimbursed shall form part of his gross income but he may deduct such expenses. (c) When an individual receives a salary plus allowance for meals and lodging, as for instance, a per diem allowance in lieu of subsistence, such allowance must be included in his gross income but the amount actually spent for such meals and lodging may be deducted therefrom.

Expenses for the maintenance and operation of a car

used exclusively in business including driver's wage, gasoline, repairs and depreciation are also deductible in accordance with Bureau of Internal Revenue Ruling No. 105.02, dated February 16, 1956.

If the car is used partly for business and partly for family or personal convenience, only that portion of the expenses attributable to the business is deductible from gross income.[244]

CANADA

In Canada, as in France, the United States, and the Philippines, the cost of entertaining other people is considered a deductible expenditure by reason of necessity in carrying on business.

As discussed previously, in the Royal Trust case, fees paid by a company for the membership of its employees in social clubs in order that they may attract business for the company are deductible from income. However, in Cohen v. M.N.R.,[245] a chartered accountant was not permitted to deduct $1,000 paid as the admission fee to a yacht club. The Royal Trust case could be distinguished from the Cohen case on the ground that, in the latter case, the payment made was once and for all. In the Royal Trust case, the expenses were incurred periodically. It should be noted that, in the Cohen case, the Minister allowed the

deduction of the annual dues to the yacht club.

With respect to direct and actual entertainment expenses, the disbursements of a lawyer in entertaining guests, 85% of whom were his clients, on the occasion of his daughter's Bath Mitzvah - a Jewish religious and social ceremony upon the daughter becoming 13 years of age - was refused deduction despite the appellant's evidence that clients had been invited with a view to entertaining them and soliciting their goodwill.[246]

As in France, the Philippines, and the United States, in Canada, Section 12(1)(h) excepts from the non-deductibility of personal or living expenses of the taxpayer "travelling expenses (including the entire amount expended for meals and lodging) incurred by the taxpayer while away from home in the course of carrying on his business.

In Benjamin v. M.N.R.[247] the appellant, a retired merchant, was precluded from deducting the cost of his travelling to a place to supervise his apartment building and collect rents. The expense was disallowed as a personal or living expense.

It should be noted that there is a pending proposal in Parliament not to allow the deduction of entertainment expenses, convention expenses, expenses in maintaining yachts, or membership fees in social or recreational clubs.[248]

There is also a proposal to impose a minimum "stand by charge" payable by owners or employees of business having car or aircraft available, or a corresponding amount should be added to income.[249]

In general, in Canada, the cost of travelling to and from work has been disallowed. The reason for disallowing expenditures in travelling to and from a place of business to the taxpayer's residence is the fact that it is not incurred in the course of carrying on the taxpayer's business, and that it is expended because the taxpayer chooses voluntarily to reside apart from his place of business.[250] Thus, the deduction claimed by a hairdresser for expenses incurred in travelling between two cities, where she maintained hairdressing businesses was disallowed.[251]

However, if the travelling expenses, such as taxi fares, were incurred because of the demands of the business of the taxpayer and not solely for his comfort and convenience, the same are deductible.[252] In this regard, a theatre and radio artist was allowed to deduct the cost of his taxi fares undertaken in travelling from one studio to another because he would not have been able, in cases of emergency, to fill his daily engagements without taxi transportation.[253]

Another important question relates to "unusual travel".

The cost of an unusual trip undertaken to obtain something liable to produce income, such as a trip to Denmark to procure an appointment as a steamship agent and to secure additional capital by way of investments from abroad,[254] or to create a new source of income, such as a trip made by the taxpayer to Europe on behalf of certain companies to confer with prospective customers with the understanding that he would get a percentage commission on European purchases,[255] is not deductible.

However, if the unusual trip is undertaken for the purpose of gaining or producing income from a business, the cost of the same is deductible.[256] In this connection, it is now settled that "... the taxpayer can best decide the method to follow in carrying on his business and, unless there is sound reason to question his method, it should be accepted in computing income."[257]

It should be noted that there is a proposal pending before the Canadian Parliament to allow the deduction of expenses incurred in the moving of residence when the transfer is to a location at least 10 miles closer to a persons's new place of work.[258] However, the expenses will be deductible only from income earned in the new locality.[259]

g.) Business Gifts.

FRANCE

In France, the costs of minor business gifts such as pencils and calendars are deductible.[260]

With respect to valuable gifts such as cars or cases of liquor, the donor is allowed to deduct the same only if he could prove that "the gifts were legal under corporation law and criminal law and that the gifts contributed to the 'progress' of the firm." [261]

Regarding the requirement of legality, it is necessary because commercial bribery is a penal offence in France.[262] To determine if the gift really contributed to the progress of the firm, in C.E. 27 November 1959, No. 44,826, it was stated that the business donor must identify the recipient of the gift in order that its real purpose and use may be verified.

UNITED STATES

In the United States, Section 274(b)(1), IRC, limits the deductibility of gifts, such as Christmas gifts to customers, to $25 annually per donee. The $25 limitation also applies to a voluntary payment by an employer to the widow of a deceased employee if the payment is excluded from her income as a gift under Section 102, IRC. The Service had formerly permitted the employer to deduct such payments in reasonable amounts.[263]

PHILIPPINES

Unlike France and the United States, there is no statutory provision authorizing busines firms to deduct the expenses for small gifts to customers, in the Philippines. There is also no revenue regulation regarding the matter. Nevertheless, it is submitted that the said expenses are deductible in reasonable amounts if the general requirements, as discussed earlier, in connection with the deductibility of business expenses are met.

CANADA

In Canada, as in the United States and France, expenses incurred by businessmen for Christmas gifts are ordinarily allowed as deductible business expenses provided they are not of a purely capital or social nature.[264]

In relation to small gifts, in the Beeson case,[265] it was stated that: "... a taxpayer is not precluded from claiming a deduction for promotion and entertainment expenses as such. This does not mean however that all promotion and entertainment expenses will be allowed as deductions, for some of them may be of a capital nature ... and some may well be of a purely social nature..."

Gifts by a company's president to buyers of theatre tickets, meals, and Christmas gifts were also held as deductible.[266]

h.) Fees

FRANCE

In France, legal, accounting, other professional fees, and advertising expenses paid to third persons for services rendered to a business firm are deductible.[267]

The privilege to deduct fees extends to expenses incurred for the advice needed by the business enterprise in the course of its operation.[268] Management fees paid by one business firm to another, even if they are payments by a subsidiary company to the parent enterprise, are deductible if the said fees do not exceed the amount normally paid for similar services.[269]

The right to deduct fees paid to third parties depends on the disclosure of the recipient. If such disclosure is made, then the amount paid as fees are deductible.[270] In the absence of disclosure, the rules discussed with respect to undisclosed recipients in connection with the payment of compensation will apply.[271]

Advertising expenses are also deductible.[272] Usually, said expenses are deducted in the year in which they are incurred. Exceptional expenditures which "are not in proportion to income realized in the year of expenditure, and which are regarded as expenses other than normal annual expenses, may be treated as organization expenses...

and written off over a period of years."[273] However, the right to deduct advertising expenses is limited. Under Article 39-4, CGI, hunting, fishing and resort expenses, even if incurred in the name of advertising are not deductible. Also, the advertising of certain spirits is prohibited under the French Liquor Code.[274] The said prohibition is reinforced by Article 237, CGI, which denies the deduction of the costs of such advertising.

UNITED STATES

In the United States, as in France, under Section 162(a), IRC, expenses for legal, accounting, other professional services, and advertising expenses, are generally deductible, unless they are required to be capitalized. Legal fees paid in connection with the acquisition of property or the defense of title to property are not deductible as business expenses and must be added to the cost of the property, although an allocation between capital and business expense is sometimes permitted.[275]

Advertising expenses, to be deductible, must be reasonable in amount and should be reasonably linked to the taxpayer's business activities.[276] This rule applies, in general, even though the taxpayer's advertising program extends over a period of more than one year and even though the advertising is aimed to create goodwill rather

than to promote the immediate sale of the taxpayer's products.[277] Deduction has, thus, been allowed for advertisements, signed by the advertiser, promoting wartime government programs such as conservation or the sale of war bonds.[278] Advertising costs have also been allowed even though the particular expense was highly personal in nature and involved the sum for an unusual "advertising media".[279] In a case, deduction was allowed for the cost of an African safari undertaken by the principal officer of the taxpayer-corporation, a dairy company, where the taxpayer later exploited the trip for publicity purposes.[280] Similarly, the cost of maintaining show horses and show dogs, and of sponsoring athletic teams, was allowed where the taxpayer was able to demonstrate that the expense had been incurred for the purpose of publicizing the taxpayer's business.[281] Expenses of identical nature have been disallowed, however, where the taxpayer failed to prove that they produced any direct business benefit in the nature of publicity or goodwill.[282]

PHILIPPINES

In the Philippines, under Section 30(a)(1), NIRC, expenses for legal, accounting, other professional services, and advertising expenses are deductible. Deductibility, however, depends upon the satisfaction of the "necessary and ordi-

nary" requirement and the fact that the expenses were incurred for the purpose of earning income. With respect to the other matters pertaining to the deductibility of the above-mentioned items, there is also no difference between the rules existing in the Philippines and those in the United States.

CANADA

As in France, the United States, and the Philippines, in Canada, subject to the general requirements regarding deductibility, expenses for professional services are deductible.

Legal expenses which taxpayers incur in connection with income earning activities are generally deductible; while those relating to capital assets are generally not deductible. This matter was already extensively discussed earlier. Suffice it to say, in the D.J. MacDonald Sales Ltd. case,[283] it was declared that legal expenses, to be deductible, must be those of the taxpayer seeking to deduct them and not those of some other individual or entity, even if there is a closer relationship between them. Fees paid to auditors in the ordinary course of business are deductible. In accordance with the Paquet case,[284] auditing fees incurred after the taxpayer's death are not deductible because they relate to the settlement of his

estate.

Advertising expenditure is so recognized in the commercial community as a legitimate business expense that its deductibility never appeared to have been questioned before the courts in Canada.[285] Nevertheless, expenditures closely resembling advertising expense have been disallowed where they appear to have contributed substantially to goodwill rather than to current sales.[286] Thus, where the appellant and other members of a stock exchange contributed to a fund organized to prevent the failure of a small firm member of the exchange, avert its bankruptcy, and to sustain public confidence in the brokerage business, the expenditure was disallowed as being an outlay in connection with a capital item and not an expense for the purpose of earning income, notwithstanding that the taxpayer's income might have been sustained as a result of the expenditure.[287]

Entertainment expenses not directly related to sales have been disallowed as capital expenditures.[288] However, expenses incurred by a brewery in "treating" drinkers as a means of boosting its sales in its own and other hotels were held deductible.[289]

The cost of a mailing list was held to be deductible as an advertising expense because it was used to increase

the circulation of a newpaper.[290] Hence, it is clear that the expense was incurred for the purpose of producing or gaining income. However, in the Southam case,[291] only a capital cost allowance was granted because the expense to secure the mailing list was made for the purpose of acquiring a capital asset.

i.) Expenses to Restrict Competition.

FRANCE

The general rule in France is that sums spent to restrict competition are not deductibleon the ground that said sums "are capital expenditures which are balanced by an increase in the networth of the payor."

In C.E. 7 January 1942, No. 68,472, a firm agreed with others to buy and close permanently a competing factory. It was held that the expenses incurred for the purpose mentioned were not deductible. Furthermore, in C.E. 20 May 1946, No. 73,519, the sum paid to a business competitor to cease activity for a period of 50 years was declared not deductible.

However, the present tendency is not to be too strict. Hence, in C.E. 17 May 1961, No. 45,534, a firm, to restrict competition, bought shares in other firms at a price in excess of the true value of the shares. Here, deduction was allowed to the extent of the difference between the

purchase price and the actual value of the shares.

It should be noted that the rule of non-deductibility does not apply to a situation where competitors set up a pool to which they make payments and from which they receive compensation depending on whether sales fall or rise.[292] An example of this would be the application of the rule laid down in C.E. 4 July 1938, No. 59,951. In this case, six breweries bought and liquidated a "dissident" brewery and set up a compensation fund to regulate competition among them. Each participant paid sums to the fund or received payments from it, depending on whether its sales in the area formerly served by the "dissident" brewery increased or decreased. It was held that the sums paid into the fund by the members were deductible.

UNITED STATES

Unlike France, in the United States, there are no exceptions to the rule that expenses to restrict competition are not deductible. It is treated as a capital expenditure which increases the networth of the payor.

PHILIPPINES

The rule in the Philippines is similar to that in the United States. Expenses to restrict competition are treated as capital expenditures, and, thus, not deductible from gross income.

CANADA

In Canada, as in France, the deductibility of payments made to stifle competition depends upon the way the contract is drawn up.

A contract requiring a competitor to refrain from day-to-day or week-to-week competition as long as payments are made to the competitor would appear to justify the deduction of the payments. However, where the contract is one for a fixed period involving a fixed amount payable either in a lump sum or by instalments, the transaction is a capital one and the payments made under it are not deductible.[293]

Expenses incurred for the purpose of preventing the establishment of a business similar to that of the taxpayer making the disbursements are also capital expenditures. Thus, a radio station operator's expenses in unsuccessfully attempting to prevent the licensing of another station were held to be non-deductible.[294]

Payments to buy out the opposition are also capital outlays.

Nevertheless, if the taxpayer buys the business of another and does not operate it, the expense would be

deductible as having been laid out to earn the income of the purchaser's original business.[295] Moreover, if no enduring benefit was gained as a result of the buying of the opposition, the payments would also be deductible. Hence, if a firm pays a competitor who is going out of business, for its promise to divert whatever business it had to the firm, the expenses are deductible.[296] There is no enduring benefit gained because there is no assurance that the newly acquired customers would continue to patronize the business of the payor.

2. Retirement and Other Benefits

FRANCE

In France, amounts paid by reason of an employee's retirement, resignation, or dismissal, including lump-sum payments and severance pays, are generally, deductible by the employer.[297]

To encourage increased employee participation and interest in business, such as participation in the share capital of the firm and sharing in the benefits of increases in productivity, tax reliefs are granted under French laws.[298] As a general rule, amounts paid to

employees under the above arrangements are deductible by the employer.[299]

Social security payments made by business enterprises for the benefit of employees, such as the cost of social insurance, levies to finance family allowances, workman's compensation, and other similar expenses, are deductible as supplemental wage payments.[300]

Pension funds in France are generally under the supervision of the French government. Contribution made by business enterprises to government supervised pension plans for the benefit of their employees are deductible from business income.[301]

In the case of private pension funds, the contributions of the employer would be deductible only if "they were reasonable in amount and if the fund consituted an independent legal entity, not under the control of the contributing employer, so that funds paid to it were not thereafter at the dispositionof the paying firm".[302]

Hence, in C.E. 3 March 1951, No. 41,813, the contributions paid by a business firm to an association organized to aid its employees were not declared deductible. The reasons were that the managers of the firm named majority of the members in the association's managing committees, payments made by the firm to the association appeared to have exceeded the amounts disbursed by the association, and the sums that were not disbursed remained at the disposition of the firm.

UNITED STATES

In the United States, an employer who wishes to provide retirement and death benefits to his employees may do so either on a funded basis or by making direct payments to the employee or his beneficiary at the time of the employee's retirement or death. If the funded method is utilized, the employer can choose between the creation of a "qualified" plan which meets the specific requirements of Section 401(a), IRC, and the use of a non-qualified plan which does not meet those requirements. The tax consequences vary, both for the employer and his employee, depending on which of these methods are adopted.

Adoption of a "qualified" pension or profit-sharing plan results in certain tax advantages, as follows: (1) the employer's annual contributions to the plan are

currently deductible from the employer's gross income in accordance with Section 404, IRC; (2) the tax on the employee is not imposed at the time the contribution is made but is deferred until the benefits are received by him, even though his rights to benefits are "vested", that is, not forfeitable in the event that his employment is terminated before he reaches the designated retirement age, pursuant to Sections 402 and 403, IRC; and, (3) if the employer's contributions are made to a trust established pursuant to the plan, the investment income of the trust is exempt from tax under Section 501(a), IRC.[303] If the plan is under the management of an insurance company to which contributions are made for annuities, the investment income from the annuity reserves likewise is not subject to tax with respect to the insurance company in accordance with Section 805, IRC. These advantages are available only if the plan meets the specific requirements of section 401(a).

Deduction for contributions to a qualified plan is authorized by Section 40, IRC, rather than by Section 162 (a), IRC. However, the contributions, to be deductible, msut meet the conditions of the latter provision also. In other words, the contribution should be an ordinary and necessary business expense, and must be reasonable in

amount when considered in connection with other compensations received by the employee for his services.

If the contributions are channelled into a pension plan, the deduction is limited to the amount required, on an actuarial basis, to meet the anticipated cost of pensions for employees on their retirement.[304] If the contributions are made to a profit-sharing plan, the deduction is limited, in general, to 15% of the compensation paid to employees covered by the plan.[305] In either case, if the amount contributed in any one year exceeds the allowable limitation, the excess may be carried forward and deducted in any subsequent year when the amounts otherwise deductible for that year fall below the limitation of that year.[306]

Death and retirement benefits may be provided for a restricted class of employees, such as executives, under a plan which does not meet the requirements of section 401(a). Under a non-qualified plan, the employer's contribution is currently deductible only if the employee's rights to future benefits are non-forfeitable at the time that the contributions are made.[307] Otherwise, the employer may not deduct the contribution, and in effect, suffers a loss of the deduction entirely.[308] In either event if a trust is employed, its investment income is not exempt from tax.[309]

As an alternative to the adoption of a funded plan, the employer may choose to take direct payment of pension and death benefits to his employees or their beneficiaries. From the employer's standpoint, such payments will be deductible when made. Since the arrangement is not a funded one, the employee being satisfied to rely on the employer's future solvency, the rules regarding the loss of deduction under non-qualified forfeitable plans are not applicable.[310] The employer's deduction is still governed by Section 404 rather than by Section 162(a). Thus, the employer, even if on the accrual method, may take a deduction for amounts paid to the employee only at the time of actual payment and may not accrue the liability prior to such time.

Voluntary pension payments to retired employees are deductible, if reasonable in amount, as ordinary and necessary business expenses.[311]

Amount paid or accrued by an employer on account of injuries, sickness, or disability of employees are deductible under Section 162(a). In accordance with Section 1.162-10 of the Regulations, contributions by an employer to a plan providing medical and disability benefits for employees are likewise deductible as ordinary and necessary business expenses.

With respect to unemployment benefits, under the

"supplemental unemployment benefit plans," the employer is bound to make annual contributions to a fund in amounts sufficient to guarantee a minimum annual wage to its employees.[312] The Service has ruled that contributions to a supplemental unemployment benefit plan are currently duductible by the employer under Section 162(a), IRC.[313] A trust created to receive the contributions normally also qualifies for exemption under Section 501(c), IRC, and, hence, investment income received by the trust is exempt from tax.

PHILIPPINES

In the Philippines, as in the United States, an employer who wants to provide retirement benefits for the employees can do it by making direct payments to the employee or beneficiary at the time of retirement or through a qualified pension plan.

Under Section 30(j), NIRC, an employer establishing or maintaining a pension trust is allowed to deduct - (i) contribution, during the year to cover the pension liability accruing during theyear; and, (ii) the amount transferred or paid during the year in excess of such deduction, provided: (a) the same has not therefore been allowed as a deduction; and, (b) the same is apportioned in equal parts over a period of ten (10) years beginning

the year in which the transfer is made.

Under BIR Ruling No. 65., February 6, 1959, the 3-½% premiums paid by the employer to the Social Security System that accrue to employees in case of death, retirement, disability or sickness are deductible from the gross income of the employer.

CANADA

In Canada, contributions of the employer to a pension fund in respect of services rendered by an employee are deductible.[314]

With respect to the deductibility of death benefits paid to the widow or other relative of a deceased employee the Department considers whether the payments are reasonable in the circumstances.[315]

If the deceased employee dealt at arm's length with the employer, and in the case of a corporation, was not a substantial shareholder, the amount of the death benefit actually paid will normally be considered reasonable even if it exceeds the employee's yearly salary.[316] Hence, it will be allowed as a deduction.

If the employee did not deal at arm's length with the employer or was a substantial shareholder of the corporate employer, the amounts paid may be considered unreasonable if they are disproportionate to the employee's

salary or to the value of the services rendered by him during his period of employment.[317] In this case, deduction will only be allowed to the extent that it is reasonable.

3. Interest

FRANCE

In France, interests paid on amounts for commercial use borrowed from third parties are deductible from business income.[318]

The exception to the above rule is where the debtor firm fails to disclose the name of the creditor receiving the interest as provided under Article 173-1, CGI. The right to deduct is lost in case of a failure to disclose the identity of the creditor. There is, however, an exception to the said exception. It refers to interests paid under a bon de caisse. Under Article 188B, CGI, Ann IV, a bon de caisse, is a debt instrument "registered payable to order or to bearer, involving or being equivalent to an agreement to pay and deliver in return for a loan." If the bon de caisse is quoted or is susceptible of being quoted on an exchange, interest on the bon may not be payable against the surrender of coupons or of instruments representing coupons.[319] Ordinarily, a debtor paying interest on a bon de caisse is required to withhold

tax therefrom, for the account of the creditor, at the rate of 24%, the creditor then receives 76% of the gross interest due, includes the amount in his taxable income, and claims a credit, against the income tax due from him for the sum withheld at the source."[320] If a debtor owing interest on the bon chooses to pay interest thereon net of tax, he may do so. In this case, he withholds nothing at the source and pays the creditor the full amount of gross interest due.[321] As a consequence, he is relieved of any obligation to disclose the name of the creditor to whom interest is paid.[322] Despite his non-disclosure and contrary to the ordinary rule, the debtor is permitted to deduct the full amount of interest paid in accordance with Article 1678, CGI, and Articles 188-B to 188-G, CGI, Ann. IV.

Where the debtor decides not to disclose the name of the bon de caisse holder to whom he pays interest, he is required to pay tax on the amount of interest paid to the holder of the anonymous bon at the rate of 50%.[323] The amount of tax paid on the interest outlay, like the interest outlay itself, may be deducted from income by the debtor as business expense.[324]

Interest-free loans are at times made between related persons. Examples would be those entered into between a French subsidiary and a French parent corporation or be-

tween a corporation and a controlling stockholder.[325] If the interest-free loan results from an ordinary decision for the benefit of the lender's business (gestion normale). the lender will not be taxed on an imputed receipt of interest, nor will the lender be denied a deduction for interest paid to a third party, say a bank, to obtain the funds lent free of interest.[326] If the interest-free loan results from reasons extraneous to the sound commercial management of the lender (Interets commerciaux etrangers a l'enterprise), and if the lender borrowed from a third party the fund that he has lent free of interest, he will be denied the right to deduct the interest paid to the supplier of the funds.[327] If the lender used his own funds, instead of borrowing, the lender will ordinarily be taxed on interet fictif (imputed receipt of interest) on the amount that a loan of the kind in question might be expected to produce.[328]

There is also the question of interest payments made to individual proprietors, partners and shareholders.

Interest payments on capital contributed or loaned by an individual proprietor to his firm are not deductible.[329]

Under Articles 39-1 to 39-3 and Article 212, CGI, although a partnership may not deduct interest paid to its

partners on their contributions to the capital of the firm, it may deduct interest paid to partners on loans made to the firm over and above their capital contributions.

The rules involving the deductiblity of interest paid to shareholders by corporations are similar to those affecting individual proprietorships and partnerships. Amounts paid by a corporation to its shareholders as "interest" on their share capital in the enterprise are not deductible.[330] However, a shareholder may lend money to his corporation over and above his equity investment in its share capital. In this instance, the corporation as debtor, may deduct interest paid to the shareholder, in his capacity as creditor.[331]

It must be pointed out that there are limitations to the deductions with respect to associates: a shareholder in the case of a corporation, a partner in case of a partnership, and a member in case of a limited liability company. Interest paid by an enterprise to an associate is deductible only to the extent that the interest rate does not exceed the rate charged by the Bank of France on security loans (5%) plus two per cent.[332] Any excess over the said rate is not deductible. There is another limitation with respect to entities subject to corporate income tax. In case "the lenders 'in law or in fact'

control the debtor ... entity ..., interest paid on their loans is deductible only to the extent that the total amount of loans from these lenders does not exceed 50% of the total capital paid in by all shareholders... (CGI, Art. 212)."[333]

Finally, we have the matter of additional principal payments on index loans. In many instances, the operation of an index clause in a loan agreement may require the debtor to repay a larger sum in France than the sum borrowed.[334] The difference is deductible from the business income in the year of payment.[335] The index clause "must be a normal one designed to protect the debtor against economic fluctuation and monetary depreciation; deduction will be refused if the index clause results in a disguised distribution of profits."[336]

UNITED STATES

As in France, in the United States, interest paid or accrued during the taxable year on indebtedness is deductible from gross income under Section 163, IRC. However, unlike in France, the Section does not require that the indebtedness be related to the taxpayer's trade or business, so that all interest charges are deductible, whether they represent a personal or a business expense. The requirements and limitations of Section 162(a), IRC,

are therefore, not relevant.

To be deductible, interest must be separately designated from the principal amount of the indebtedness.[337] Moreover, the indebtedness must be that of the taxpayer claiming the deduction.[338] Lastly, the indebtedness must be bona fide and must have been incurred for reasons other than mere tax avoidance.[339]

Classification of the instrument under which the payments are made is sometimes difficult. The intention of the parties, as determined from all the facts and circumstamces is the controlling factor.[340]

The characteristics of an instrument of indebtedness are: a definite obligee;, a definite ascertainable obligation; and, a time maturity that is definite or that will become definite.[341] "Indebtedness" does not mean any obligation of whatever nature. "Interest on indebtedness" is restircted only to the amount one has to pay for the use of borrowed money.[342]

If, in accordance with the foregoing tests, the transaction is not actually payment of "interest from indebtedness", there can be no deduction.

Thus, in Knetsch v. United States,[343] an annuity was purchased with funds borrowed from the issuing insurance company. The Court characterized the transaction as a

sham and disallowed the interest paid on the purported loan.

Moreover, if the interest for borrowed money is used to purchase tax exempt securities, no deduction will be allowed.[344]

The rules, obtaining in France, with respect to the deductibility or non-deductibility of interest-free loans, do not exist in the United States. There is no taxation of presumptive income, as distinguished from income that is economically real, in the United States.[345] Hence, there can be no question regarding the deductibility or non-deductibility of the same.

PHILIPPINES

As in the United States, in the Philippines, Section 30(b),NIRC, allows deduction of interest paid or accrued on indebtedness except on those incurred or continued to purchase or carry obligations the interest upon which is exempt from income tax. It is clear that the only interest that is not deductible refer to those incurred to purchase tax free obligations. The idea of the exemption is the prevention of tax avoidance.

The conditions precedent to the deductibility of interest paid as follows: (1) there should be an enforceable obligation or indebtedness, (2) the obligation must bear interest, and (3) what is claimed as an interest deduc-

tion must have been paid as accrued within the year.[346]

As in the United States, Philippine law does not distinguish whether or not interest is connected with trade or business. Interest, therefore, is a deductible item even if it is of a personal nature.

The statutory term "interest on indebtedness" is not all embracing. Thus, in the case of Kuenzle, and Streiff, Inc. v. Commissioner of Internal Revenue,[347] it was held that interest on unpaid salaries and bonuses is not deductible, the meaning of said salaries and bonuses not falling within the term "indebtedness" as mentioned in the Tax Code. It is well-settled rule that the term "indebtedness" is restricted to its usual import which "is the amount one has contracted to pay for the use of borrowed money."

Interest on preferred stock, which is in reality a dividend thereon, cannot be deductedin computing net income.[348]

Official opinion as well as court decisions, however, have passed upon the question of deductibility or non-deductibility by going into the substamce rather than form as to whether the so-called dividend or interest on preferred share of stock is capital investment or an obligation.

In this regard, portions of the ruling of the BIR dated April 27, 1953, in the case of the Insular Life

Assurance Company, are quoted hereunder:

> "Reference is made to your letter dated ... requesting that the sum of ₱47,681.50 covering the "dividends on preferred stocks" paid to the Rehabilitation Finance Corporation, be allowed as deduction from your gross income for the year 1951.
>
> "In reply thereto, I have the honor to inform you that as the advances made by the Government to your Company under the provisions of Executive Order No. 107 dated April 20,1946, were substantially in the nature of loans but treated only as capital stock in order to place your company on legal capital basis and also to enable the Government to participate in your management..., your request is hereby granted.
>
> "Furthermore, although in the provincial certificate issued by your company to the Financial Rehabilitation Board of the Government of the Philippines these advances were referred to as preferred stocks and entitled to dividends payable out of the net profits, evidence, however, shows thatthe dividends were not necessarily paid out of the net profits because even when losses were sustained in 1947, payments were nevertheless effected, justifying your allegation that said payments were in the nature of interest."

However, in the case of the Philippine Trust Company v. Collector of Internal Revenue,[349a] distinction was made as to whether payments made on preferred shares of stocks are dividends or interests While the taxpayer called them "interests" it was held that they were in fact "dividends" and not deductible. The Court explained that payments made by a corporation on its shares of stock are dividends (not deductible), but payments made on its evidence of indebtedness are interests (deductible). It

was pointed out that the records did not show that the preferred shares issued by petitioner were in reality merely evidence of indebtedness. It did not appear that the so-called interests on the preferred shares were payable only out of the profits or earnings of the petitioner or that they were payable regardless of any profits or earnings. It was not also shown whether or not the preferred shares had a definite date of maturity.

As in the United States, there is no taxation of presumptive income in the Philippines. Thus, there is also no problem concerning the deductibility or non-deductibility of interest on presumptive income.

CANADA

As in France, in Canada, Section 11(1)(c), (ca) and (d), ITA, permit the deduction of a reasonable amount of interest and compound interest on borrowed money used for the purpose of earning income from a business or property and on money owing for property acquired for the purpose of gaining or producing income from that property or from a business.

In accordance with North America Construction v. M.N.R.,[350] to come within Section 11(1)(c), interest must be paid pursuant to a legal obligation to pay interest.

Moreover, to be deductible under Section 11(1)(c),

the amount in question must be a true interest payment.

In order to find a true interest payment, it is necessary that there be a borrower-lender relationship. Due to the absence of such a relationship, the following disbursements were not considered as expended for interests: 1) remuneration paid to a guarantor of a taxpayer's loan from a bank;[351] 2) security denominated as "preferred shares" issued for a fixed interest rate and payable without regard to whether profits were earned or not;[352] and, 3) payments made by a mutual insurance corporation to certain credit unions arising from their contributions because there was no legal obligation on the part of the corporation to pay interest on the contributions, and the credit union had no recourse regarding the recovery of their money.[353] Interest on corporate income bonds, except those of personal corporations, is expressly disallowed, with narrow exceptions, by Section 12(1)(f) of the Act.

Interest paid on borrowed money used for some purpose other than to earn income from a business or property is not deductible under Section 11(1)(c). Interest paid on a bank loan used to purchase a residential property for the taxpayer's own use was disallowed.[354] However, interest paid on a bank loan was held deductible where the taxpayer

was able to prove that the bank loan was used to purchase income-producing stock.[355]

In Hudson v. M.N.R.,[356] it was declared that the manner of use of the money borrowed remains in the taxpayer's discretion so long as he can justify the way it is used on business principles.

As in the Philippines and the United States, in Canada, the interest on borrowed money used to acquire property the income from which would be exempt is not deductible under Section 11(1)(c). If money is borrowed to repay a loan used to acquire property that produces exempt income, the question arises whether the interest on the second loan would be deductible.[357] Section 11 (3b), ITA, answers the question by providing that borrowed money used to repay money borrowed previously, shall be deemed to have been used for the same purpose as the original loan. Hence, if interest on the original loan was not deductible because the loan served to acquire property the income from which would be exempt, the interest on the second loan would not be deductible either.

The deduction of interest payments must not exceed a reasonable amount. The question of reasonableness should be determined by the court in the light of all surrounding circumstances. Under Section 11(3a), ITA, a

taxpayer who has borrowed money in consideration of a promise by him to repay a larger amount and to pay interest on a larger amount is deemed to have borrowed the larger amount. The bigger amount is deemed to have been used for the purpose of earning income in the proportion that the amount actually used bears to the amount actually borrowed. Interest is deductible on the portion of this larger amount.

Section 7, ITA, provides that a part of a payment under a contract or arrangement that can reasonably be regarded as a payment of interest or otherwise of an income nature must be included in computing the recipient's income. This is analogous to the doctrine of "presumptive income" prevailing in France. Thus, in the Groulx Case,[358] the price of a property sold above its market value and payable in installment without interest was held to include interest.

It should be noted that Section 11(1)(d), ITA, permits a reasonable portion of the payment included as income of the recipient to be deducted by the payer if the payment was made by way of repayment of borrowed money or by way of purchase of property, within limitations similar to those of clauses (i) and (ii) of Section 11(1)(c). The purpose of the provision is to permit the deduction of an otherwise deductible interest payment that is found to be

combined with a capital payment upon being considered from the standpoint of the payee under Section 7.[359]

4. Dividends

FRANCE

In France, dividends paid are not deductible from business income.

However, by a decree in 1957, corporations were allowed to deduct from taxable income dividends paid on new shares, issued at the organization of a new corporation or on an increase in the capital of an existing corporation, if the sums paid in for the shares are used in connection with plans for modernization.[360]

The deduction privilege is available only to corporations organized or issuing new shares after the effective date of the 1957 decree, and only if the organization of the corporation, or the increase in capital, has been approved by a decree of the Minister of Finance and Economic Affairs issued after consultation with the Board of Directors of the Economics and Social Development Fund.[361]

The right to deduct is available for seven years.[362] For an already existing corporation, the first year of deduction is the year during which the new shares are sold.[363] For a new corporation, "the first year is not

the year of incorporation, but the fourth year of the corporation's existince; this rule is designed to permit the firm to recover its initial losses and launching costs."[364] Hence, the deduction is available in the fourth through the tenth year of the corporation's existence.[365]

The amount of the dividend deductible in any year is limited to 5% of the cash sum paid into the corporation for the new shares.[366]

The expiry date for the right to issue shares that could qualify for the dividend deduction was December 31, 1965.[367] Presently, there are still corporations in France enjoying dividend deduction rights under the decree of 1957.

UNITED STATES

Unlike France, in the United States, there is no exception to the rule that no deduction is allowed to a corporation for amounts distributed as dividends. Thus, in effect, the corporate earnings are taxed once when received by the corporation and a second time if distributed to shareholders.

Under Sections 116, ITA, in the case of an individual shareholder, the first $50 of dividends received from domestic corporations is exempt from tax. Further, a credit against tax equal to 4% of dividends received in

excess of $50 is allowed, subject to certain limitations in accordance with Section 34, ITA. In the case of a corporate shareholder, a deduction is allowed for 8% of all dividends received from domestic corporations and from certain foreign corporations pursuant to Section 243, ITA.

PHILIPPINES

In the Philippines, as in the United States, no deduction whatsoever is allowed with respect to dividend distributions.

However, under Section 29(e), NIRC, dividends received by domestic and resident foreign corporations from domestic corporations are not subject to tax to the extent of 75% of the amount received as dividends. This exemption is similar to that existing in the United States. The only difference is that, in the United States, the exemption extends to 85% of the amount of dividends received. In the Philippines, there is no exemption with respect to amounts received by individuals as dividends. There is also no provision granting tax credits to individuals regarding dividends already subjected to tax in the corproate level.

CANADA

In Canada, as in the United States and the Philippines, the paying corporation is also not allowed deductions for

dividends payments. They are paid voluntarily by the corporation to compensate for share capital contributed to the corporation, and could probably also be described as "a payment of income after it has been earned" - the phrase used in disallowing the deduction of payments in cases arising under Section 12(1)(a) and (b) of the Act.[368]

Thus, in The Bay Co. (B.C.) Ltd. Case,[369] a company, which was formed as a subsidiary of two American companies to take over a contract for the building of the Canadian portion of a pipeline, agreed to pay to the mother companies cost plus 10% as basic compensation for materials and equipment purchased and supplied by them. It also contracted to pay cost plus 10% as basic compensation for technical assistance and supervision rendered and, in addition, 50% of its funds realized on the contract. The deduction of payments made pursuant to the agreement to pay 50% of what is realized on the contract was disallowed on the ground that the sums represented either a division of profits after they had been earned, or alternatively, that the amounts represented the purchase price of the contract turned over by the mother companies and, consequently, capital payments.

However, Section 28, ITA, provides that a corporation that received a dividend from another corporation is not

taxable on the amount of that dividend. The amount of this deduction is equal to the full dividend received from those corporations, less any allowance under Section 11(2) defined by Section 39(1)(k), ITA, to exclude a stock dividend. Nevertheless, under Section 81(4), ITA, that portion of any stock dividend included in computing a corporation-shareholder's income is deemed to be the amount of a dividend received by the corporation-shareholder for the purposes of Section 28. It should be noted that, unlike Canada, in the United States and the Philippines, the dividend credit is not for the full amount received by the corporation.

Presently, there is a 20% dividend tax credit for Canadian resident shareholders with respect to dividends from taxable corporations resident in Canada, or from a corporation, the shares of which were listed on a prescribed Canadian stock exchange having not less than 85% of its income from business carried on in Canada.[370]

In lieu of the said dividend tax credit, there is a pending proposal before the Canadian Parliament to give Canadian residents the benefit of half integration with respect to dividends received from all Canadian corporations resident in Canada, whether widely or closely held.[371] Under this system, Canadian residents will be receiving

dividends free of tax on one-half of the same.

5. Bad Debts

FRANCE

In France, a debt that becomes unrecoverable during a tax year is deductible for that year. If the debt does not appear to be clearly unrecoverable, but non-payment is wholly or partially very probable, a deductible reserve for bad debts may be set up to meet the risk of loss. However, the reserve must be based on an evaluation of specific items.

A reserve simply to meet the general risks of non-payment is not deductible. Thus, in C.E. 9 April 1956, Nos. 25,244, 34,376, an allocation to reserve based on the percentage of outstanding debts, not exceeding the premiums charged by the credit insurance company, was held non-deductible.

In France, due to the categorized method of computing income, a bad debt not arising from business cannot be deducted from business income.

UNITED STATES

Debts which become worthless during the taxable year are deductible from gross income under Section 166, IRC.

If the debt is a "business" debt, it may be deducted when it becomes wholly worthless. It may also be deducted

when partially worthless to the extent that it is charged off during the year.[372] In lieu of deducting each debt directly as it turns worthless or partially worthless, the taxpayer may set up a reserve for bad debts and take a deduction each year for additions to that reserve, the amount of the deduction usually being equivalent to a percentage of the total debts arising from the taxpayer's business for the year.[373]

To be deductible under Section 166, a debt must be based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.

If the taxpayer's principal intention was to make a gift, or if the loan was made with no real intention of enforcing the debtor's obligation, no deduction for a bad debt will be allowed.[374]

Similarly, if the loan is contingently repayable, the deduction will be denied even though the taxpayer's right to repayment would be enforceable if the contingencies occurred.[375] Thus, a bad debt deduction was not allowed where a husband advanced money to his wife for her to purchase the stock of an insolvent company and the loan was to be repaid only if the profits of the business were sufficient to allow repayment.[376]

Moreover, even if the debt is valid and unconditional,

no deduction will be permitted if, at the time the loan was made the taxpayer had no reasonable hope that it would be repaid.[377] Hence, it has been held that advances by a shareholder to an insolvent corporation which the shareholder wanted to keep alive did not give rise to a bad debt deduction, the shareholder having no expectation of repayment.[378]

Proof that the debt has become worthless during a taxable year can easily be made where an identifiable event, such as the bankruptcy of the debtor, has actually occurred in that year.[379] Otherwise, the taxpayer may succeed in proving that a debt became worthless in a taxable year only by showing that active steps were taken unsuccessfully in that year to collect the obligation from the debtor.[380] A legal action is not required if the surrounding facts and circumstances indicate that the debt was actually worthless and uncollectible.[381]

Section 166(b) provides that the basis for determining the amount of a bad debt deduction "shall be the adjusted basis ... for determining ... loss." Thus, the deduction is, in general, limited to the taxpayer's cost. Moreover, a taxpayer is entitled to a bad debt deduction only if an actual cash loss has been suffered, or if the amount deducted represents an item which has already been included in

the taxpayer's gross income.[382]

Payments under a guarantee are generally deductible as a bad debt to the extent that the guarantor is unable to recover the amount paid from the principal debtor. Hence, in Putnam v. Commissioner,[383] it was held that payments by an individual stockholder as guarantor of the obligations of his corporation are to be regarded as giving rise to a non-business bad debt deduction, rather than to a deductible loss. Section 166 (f) provides that payments by a guarantor of the obligations of a non-corporate debtor are to be treated as a bad debt if the payments are made at a time when recoupment from the principal debtor is impossible, but then specifically accords a business bad debt deduction to such a guarantor.

PHILIPPINES

As in the United States, in the Philippines, Section 30(e), NIRC, provides that debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year are deductible from gross income. As in the United States, the "bad debts" need not be "business debts" to be deductible.

In considering when debts are deductible, there must be a valid debt arising out of an actual debtor-creditor relationship. The important underlying principle is that

no valid debt exists unless there is an unconditional obligation of another to pay the taxpayer.

Furthermore, the debt must be ascertained to be worthless and charged off during the year.

The ascertainment of worthlessness requires proof of two facts: (1) that the taxpayer did in fact ascertain the debt to be worthless in the year for which deduction is sought; and (2) that, in so doing, he acted in good faith.[384]

In ascertaining whether a taxpayer acted in good faith, it is reasonable to inquire whether a prudent businessman would have decided as the taxpayer did.[385] The prudent businessman's test may also be applied in ascertaining if the taxpayer made the same investigation of the facts upon which he based his decision of the worthlessness of the debt.[386] The requirement of good faith implies a reasonably diligent and thorough investigation to determine the status of the debtor, his capacity, and intention to pay.[387]

In relation to good faith, Section 102 of Revenue Regulations No. 2, provides that: "Where the surrounding circumstances indicate that a debt is worthless and uncollectable and that legal action to enforce payment would, in all probability, not result in the satisfaction of

execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts."

The law requires that the debt should not only be ascertained to be worthless but also charged off within the taxable year. The term "charged off" applies to taxpayers who are required by law to keep books of accounts where the corresponding indebtedness or accounts receivable is recorded.[388] The fact that a receivable is written off in the books of the taxpayer is additional proof of good faith on the part of the taxpayer in claiming the same as worthless and uncollectible.[389] A "mental charge off" is, however, sufficient where the taxpayer keeps no books.[390]

The fact that there was recovery in a later year does not preclude the deductibility in the year the debt was ascertained to be worthless.[391]

There is no specific provision in the Philippine Tax Code with respect to the right of the guarantor to deduct from income debts not recovered from the principal debtor as in the U.S. Nevertheless, it is probable that Philippine Courts would adopt the same rule.

CANADA

CANADA

In Canada, Section 11(1)(f), ITA, provides that in computing the income of a taxpayer for a taxation year there may be deducted the aggregate of debts owing to the taxpayer (i) that are established by him to have become bad debts in the year and (ii) that have been included in computing his income for that year or a previous year. The latter requirement of previous inclusion in computing income does not apply to debts arising from loans made in the ordinary course of business by a taxpayer carrying on the business of lending money, which, while incurred on income account and therefore entitled to deduction, have never been previously included in computing income.

As in France, the United States, and the Philippines, bad debts are deductible in the year in which they are established to have become bad and that no attempt is made to relate this deduction to the year in which the debts became owing in Canada.

Where debts that have been deducted for having become bad are later in fact paid, provision is made for again bringing them into income by Section 6 (1)(f), ITA. It states that in computing the income of a taxpayer for a taxation year there shall be deducted amounts received in the year on account of debts in respect of which a deduction

for bad debts has been made in computing the taxpayer's income for a previous year, whether or not the taxpayer was carrying on the business in the taxation year.

Hence, as in France, no deduction may be made for bad debts that were not incurred on revenue account and represent capital loss or capital expenditure, or that represent debts outside the area of the business or trade carried on.

In No. 75 v. M.N.R.,[392] a creditor of a corporation accepted preferred shares of the corporation in satisfaction of the debt. The shares later turned out to be worthless. It was held that the consequent loss was a capital loss disallowed by Section 12(1)(b) and was not deductible as a bad debt. However, a non-recoverable advance payment of rental that was shown to have been made as an authorized business loan for the purpose of gaining income and not as a capital investment was allowed to be deducted as a bad debt.[393]

A bad debt should be distinguished from a capital loss. Bad debts are deductible and capital losses are not. In Dessin General Drafting Inc. v. M.N.R.,[394] the appellant company discovered that one of its officers, who held 40% of its shares and was its secretary and director, had misappropriated funds in the amount of $10,200. The offi-

cer agreed to sign an acknowledgment of the debt in the amount of $7,200. However, the officer did not make any payments. When all the efforts to collect the debt proved futile, the appellant deducted the amount of $5,000 as a bad debt in computing its income. It was held that the amount misappropriated was not an outlay or expense incurred for the purpose of gaining income for the company but was a capital loss within the meaning of Section 12(1)(b). Hence it could not be deducted under Section 11(1)(f). Unlike amounts stolen or misappropriated by a clerk or an employee on wages or salary which may be deducted under Section 11(1)(f), a theft or misappropriation committed by a senior official of a company is in the category of "loss of capital."

Bankruptcy or insolvency of the debtor are clear indications of uncollectibility.

Section 11(1)(f) seems clearly to place on the taxpayer the burden of establishing the debt to have become bad. Under No. 415 v. M.N.R.[395] it is not necessary to sue the debtor to judgment. Yet, some serious effort to collect payment must be demonstrated. The debts must have been still owing. Thus, assigned debts cease to be qualified for bad debts deduction.[396]

In Canada, as in the United States, France, and the

Philippines, an annual deduction is allowed for outstanding debts whose collectibility is in question. This is done by an annual deduction of a reasonable amount as a reserve, or adjustment, for debts that are estimated to be in doubt.[397]

Section 6(1)(e), ITA, requires that the amount deducted as a reserve for doubtful debts in the previous taxation year shall be included in computing income.

The amount of deductible reserve must be reasonable. In a case,[398] a taxpayer, in setting up a reserve for doubtful debts, took into account only the time element. He considered as doubtful account receivables, not paid within a certain time. The Board held that this approach was not reasonable. It was pointed out that other considerations should also be taken into account, such as the financial position of the debtor, history of the account, past experience in writing off bad debts, sales volume, credit collections, and prevailing business conditions.

In the Pitt Distributing Co. Ltd. case,[399] an estimate of non-payment due to future anticipated foreign exchange restrictions was held to be a "contingent" reserve, prohibited by the Act, and the doubtful debts reserve was confined to doubt due to anticipated default by the debtor.

6. Contributions and Research Expenses

FRANCE

In France, with respect to charitable contributions, if a direct benefit flows to a firm, or to its employees, from a contribution to a welfare, social, or similar group, the amount paid is a deductible business expense.[400]

Thus, in R.M. 14,940, J .O. 16 November 1922, Deb. Ch. p. 3177, payments made by a firm to organizations whose aim is to ameliorate the living conditions of its employees were considered deductible.

Furthermore, in the Letter of 6 November 1942, from the Director of Taxes to the Secretary of State for Labor, it was declared that a firm's contribution to its employee's garden societies, dispensaries, or vacation colonies are deductible if they result in benefits or advantages for the employees, such as bargain vacations or a better choice of garden locations.

Nevertheless, the judgment in every case depends on the facts obtaining and the extent to which the enterprise or its employees are the "prime beneficiaries." In C.E. 23 November 1936, it was held that sums spent by a firm for the construction of a church to serve a community in which the firm was located and a neighboring community were not considered deductible. In this case, it could be

seen that the church would also benefit non-employees of the firm in the commune where it was located and neighboring commune. Hence, the deduction claimed was disallowed.

Business enterprises are also allowed to deduct, without limit, gifts and subsidies to various organizations whose purpose is the construction of low cost housing under Article 39, CGI, in relation to Articles 41-A and 41-B, CGI, Ann. III.

Aside from the foregoing, the right to deduct charitable contributions is very limited. Under Article 238, CGI, a business firm may deduct contributions to philanthropic, educational, scientific, social and welfare organizations only to the extent of 0.1% of the same for each income year. Moreover, only organization carrying on activity in France qualify for the deduction. It should be noted that individuals, as distinguished from corporations, are allowed to deduct 0.5% of taxable income for contributions that have a scientific, philantrophic, educational or social character.

In connection with research and development expenses, three methods of deducting are available to business firms: "(1) deduction as an ordinary business expense, unlimited in amount, for research and development work carried on by the firm itself; (2) deduction, up to a maximum of 0.1% of

turnover, of contributions to non-profit organizations, including, but not limited to, those engaged in scientific research; and (3) deduction, up to an additional maximum of 0.2% of turnover, of contributions to organizations engaged in research and approved by the government for that purpose."[401]

UNITED STATES

In the United States, corporations are allowed, under Section 170(b)(2), IRC, to deduct charitable contributions of up to 5% of their taxable income for the year and to carry forward for the two succeeding years any excess over the 5% limitation. With minor exceptions, the limitations which apply to individuals with respect to qualified donees are applicable to corporations.[402] In addition, corporations are allowed a deduction for contributions to a trust, chest, fund, or foundation organized for charitable purposes only if the contribution is used within the United States or its possessions.[402A] The restriction does not apply to charities organized in corporate form.[403]

Section 162(b), IRC, prevents deduction as a business expense of any disbursement which would otherwise be deductible as a charitable contribution under Section 170, were it not for the 5% limitation on the same. If Section 170 does not apply, as where a foreign donee is involved, a

corporation may obtain a deduction if the contribution is directly connected with the business and is donated with the hope of financial return.[404]

Section 174(a), IRC, permits the taxpayer, at his own choice, to deduct as current expense certain research and experimental costs which are incurred in his trade or business.

Pursuant to Section 174(a), the taxpayer may elect to deduct all of his research and experimental expenditures rather than to capitalize any part thereof. This method enables the taxpayer to avoid the considerable accounting difficulties that would otherwise arise from allocating research costs to specific projects.[405] If the taxpayer adopts the current expense method of treating research and experimental costs, he, generally may, nevertheless, with the Commissioner's consent, elect to capitalize such costs in connection with a particular research project.[406] If the taxpayer does not elect to treat research and experimental costs otherwise chargeable to a capital account as a current expense, such costs will be capitalized.[407]

The term "research and experimental expenditures", generally, encompasses all the expenses incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention or similar

property, and the improvement of existing property of the same type.[408] It does not include expenditures for depreciable equipment utilized for research.[409] It also does not cover expenditures for management surveys, efficiency studies, consumer surveys, advertising, or the cost of testing or inspecting materials or products.[410] While the cost of developing and obtaining a patent, including attorney's fees, is included within the meaning of the term, in accordance with Section 1.174-2 of the Regulations, the cost of acquiring another person's patent, production process, or other such property is not.

Section 174 does not apply to any expenditures for the acquisition or improvement of land, or to the cost of acquiring depreciable property.

Moreover, Section 174 does not require that the actual work of research and experiment be performed by the taxpayer himself. Thus, payments for research and experiment carried on in the taxpayer's behalf under a contract with a research institute, university, foundation, engineering company, or identical contractor may similarly, at the taxpayer's election, be deducted currently or be amortized over a five-year period under Section 174(b).

PHILIPPINES

In the Philippines, under Section 30(h), NIRC, con-

tributions or gifts are deductible from gross income as long as they are actually paid or made within a taxable year to the following:

i) The government of the Philippines or any political subdivision thereof for exlusively public purposes. It is not sufficient that the contributions should be made to the government. The law provides that the donation or contribution be for exclusively public purposes. Thus, in Roxas v. Court of Tax Appeals,[411] the contributions made by the taxpayers to the Christmas Funds of the Pasay City Police, Pasay City Firemen and Baguio City Police were held not deductible for the reason that the Christmas funds were not spent for public purposes but as Christmas gifts to the families of the members of the mentioned government agencies.

ii) To a domestic corporation or association organized and operated exclusively for religious, charitable, scientific, athletic, cultural or educational purposes or for the rehabilitation of veterans, or to societies for the prevention of cruelty to children or animals and no part of the net income of which inures to the benefit of any private stockholder or individual. In the Roxas case, the contributions to the Philippines Herald Fund by the taxpayer for Manila's neediest families were also disallowed

on the ground that the Philippines Herald is not a corporation or an association contemplated under Section 30 (h), NIRC. The corporation mentioned in the Tax Code is one, no part of the net income of which inures to the benefit of any stockholder. Nevertheless, because the contributions were not made to the Philippines Herald but to a group of civic-spirited citizens organized by the Philippines Herald solely for charitable purposes, the Court ruled that this group falls within the definition of an association organized exclusively for charitable purposes and, therefore, the contribution was held deductible.

The corporations which are recipients of the donation or contribution must be domestic so that the contribution may be allowed as a deduction from gross income. Section 116 of Revenue Regulations No. 2 provides that "contributions will only be allowed as deduction when the taxpayer attaches to his return the receipt duly signed by the responsible officers of the corporations or associations to which the contributions or gifts have been paid or made. The Court of Tax Appeals, in Belen E. Ramirez v. Commissioner of Internal Revenue,[412] held that Section 116 of Revenue Regulations No. 2 requiring the presentation of receipts for charitable contribution is merely adopted "for the convenience and facility of the Bureau of Internal

Revenue, in varying income tax returns. This administrative requirement cannot deprive the taxpayer of his right to prove his contributions in accordance with the rules of evidence. Deduction of amounts contributed to charity is based on public policy, and provisions allowing deductions of charitable contributions should not be narrowly construed."

It should be emphasized that the allowable deduction for contributions should not exceed 6% of the taxable net income in the case of individuals and 3% with respect to corporations computed without deducting the contributions.[413] This limitation, however, is not applicable under certain instances wherein contributions to specified entities are governed by special laws.[414]

CANADA

In Canada, under Section 27 (1)(a), ITA, the aggregate gifts made by a taxpayer in the year (and in the immediately preceeding year, to the extent of the amount thereof that was not deductible under the ITA in computing the taxable income of the taxpayer for that immediately preceeding year) to (i) registered Canadian charitable organizations, (ii) housing corporations resident in Canada covered by Section 62 (1)(a), ITA, (iii) Canadian municipalities, (iv) United Nations or agencies thereof, (v) universities outside Canada prescribed to be universities

the student body of which ordinarily includes students from Canada, and (vi) charitable organizations outside Canada to which Her Majesty in right of Canada has made a gift during the taxpayer's taxation year or the 12 months immediately preceeding that taxation year, not exceeding 10% of the income of the taxpayer for the year, are deductible from income.

Pursuant to said provision, a donation to the Salvation Army for specified beneficiaries was held to be deductible.[415] A gift to a foundation for the advancement of knowledge was also held to be deductible.[416] However, fees paid by a taxpayer for the religious eduction of his children were held not deductible.[417] Where the donor's children enjoyed something in return for the gift given, no deduction was allowed.[418] A gift to an organization outside Canada was, also, held to be not deductible.[419]

Under Section 27(1)(a), the gift must be proven by filing receipts with the Minister. Nevertheless, it should be emphasized that the receipt for a charitable donation is not binding upon the Minister.[420] He may reject it and look into other evidence available to him. But, if the Minister is unable to prove otherwise, the receipt is valid for the full amount.[421]

Charitable donations are not normally deductible as a

promotional expense. However, in the Olympia Floor and Wall Tile Co. Ltd. Case,[422] it was held that if it was shown that the donations were for the purpose of increasing a company's sales, and did, in fact, increase them, an exception should be allowed.

Under Section 27 (1)(b), ITA, gifts to her majesty are also allowed as deductions. In the Richardson Case,[423] it was held that improvement of a farm leased from the government is not a gift to the crown.

In accordance with Section 27 (3), ITA, a resident of Canada who commutes to his place of employment in the United States is allowed a deduction for gifts to a religious, charitable, scientific, literary or educational organization created under the laws of the United States to the extent allowed and in accordance with the provisions of Section 27(1)(a).

Taxpayers may, by Section 11(1)(j), ITA, deduct in computing income for a taxation year such expenditures on scientific research as they are permitted by Sections 72 and 72A, ITA. Section 72 permits the deduction of scientific expenditures of a current nature made in Canada in the year on designated forms of scientific research. The amounts are deductible only if the taxpayer carried on business in Canada in the year of expenditure. Moreover, the deduc-

tion must be made in the year in which the expenditure is made, Scientific research is defined by Part IXX of the Income Tax Regulations and by Section 72(2). The Minister of National Revenue may obtain the advice of the National Research Council, the Defence Research Board or any other agency or department of the Government of Canada carrying on activities in the field of scientific research as to whether any particular activity is scientific research.[424]

Deductible expenditures include the following: (a) expenditures on scientific research related to the business and directly undertaken by or on behalf of the taxpayer; (b) payments to an approved association that undertakes scientific research related to the class of business carried on by the taxpayer; (c) payments to an approved university, college, research institute, or other similar institution to be used for scientific research related to the taxpayers class of business; (d) payments made in Canada to a corporation constituted exclusively for the purpose of carrying on or promoting scientific research and qualified for tax exemption by Section 62(1)(gc) of the Act; and, (e) payments to a corporation resident in Canada for scientific research related to the business of the taxpayer.[425]

Furthermore, qualified taxpayers may deduct an amount equal to the lesser of (a) capital expenditures made in the

taxation year ending after 1958 on scientific research relating to the taxpayer's business and directly undertaken by or on behalf of the taxpayer, or (b) the undepreciated capital cost to the taxpayer of property acquired for scientific research (other than land) as of the end of the taxation year.[426]

7. Losses

FRANCE

In France, with respect to ordinary losses, it is necessary for the same to be deductible, that the losses be definitive and not merely probable.[427] It must also be an actual loss rather than just an expenditure to acquire an asset.[428] If insurance is obtained or the loss is charged to a reserve, only the excess of the loss over the insurance recovery or reserve charge is deductible.[429]

Thus, losses due to theft, embezzlement, fire, flood or other casualties are deductible. However, the losses should relate to inventory and other items held for sale in the normal course of trading.

Capital losses are also classified as either short-term or long-term losses. Capital losses can not be deducted from ordinary gains or profits. Short-term capital losses are deductible only from short-term capital gains. In like manner, long-term capital losses can only be deduc-

ted from long-term capital gains. The rules for determining whether a capital gain is long-term or short-term apply with respect to long-term or short-term capital losses.[430]

Most of the rules obtaining in the United States regarding tax avoidance by utilizing the principles pertaining to the deductibility of losses have not yet been adopted in France.

UNITED STATES

In the United States, Section 165(a), IRC, provides for the deduction of "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

Section 165(a) applies only with respect to uncompensated losses. If a loss is compensated for by insurance or otherwise, it is, to the extent of such compensation, not deductible. In United States v. S.S. White Dental Mfg. Co.,[431] the taxpayer had a claim for reimbursement with respect to which there was a reasonable prospect of recovery. It was held that the loss could not be deducted until the claim was settled or denied. In accordance with Section 1.165-1(d) of the Regulations, if the taxpayer's right of reimbursement is doubtful, the taxpayer may deduct the loss in the year in which it was incurred. If reimbursement is received in a subsequent year, the amount

thereof is includible in income in the subsequent year.

The loss must relate to existing assets, and not to anticipated income or expected profits unless previously included in the taxpayer's income. Thus, no deduction is allowed for the loss of future salary upon the cancellation of an employment contract, the loss of future rents upon the cancellation of a lease, or the failure to realize anticipated bond interest by reason of the debtor's default.[432]

The loss must be a loss of the taxpayer who claims the deduction, not that of another taxpayer.

The term "loss" refers, of course, to the taxpayer's failure or inability on a sale or other disposition of property to recover his full adjusted basis for the property, which is normally his cost less prior depreciation.[433] The amount of the loss is simply the excess of the taxpayer's adjusted basis for the property over the amount realized on the sale or other disposition.[434]

In the case of real property, in addition to a loss deduction on the sale of the property, an allowable loss may also be acquired if (1) the property becomes worthless during the taxable year, and (2) the taxpayer takes some action which constitutes an "abandonment" of the property.[435]

In determining whether worthlessness has occurred

during the taxation year, the courts have, generally, shown a tendency to accept the taxpayer's appraisal of the property as worthless, unless it clearly appears that the property, or some portion of it, has a continuing and substantial value.[436]

As to whether there is an overt act of abandonment, "the courts generally insist upon the presence of an identifiable event indicating a complete termination of the taxpayer's interest in the property."[436A] Thus, an abandonment was found where taxpayers voluntarily conveyed their property to the local taxing authority or to the mortgagee, where a taxpayer refused to pay further property taxes or to meet further expenses of the property, such as insurance costs, and, where a landlord compelled his tenants to vacate leased premises by notifying them that the building would be closed.[436B]

Intangibles, such as trademarks and subscription lists, may also be "abandoned." Expenditures which must be capitalized, such as certain corporate organizational costs, are considered to be abandoned and, hence, deductible when the business is terminated.[437]

With respect to corporate taxpayers, losses sustained during the taxable year are deductible under Section 165(a). Since every corporate enterprise is presumed to be carrying

on a business for profit, the corporate taxpayer may deduct any loss which is uncompensated and which can be shown actually to have been suffered in the year for which the deduction is claimed.[438]

As to an individual engaged in trade or business, a loss arising in the trade or business is deductible under Section 165 (c) (1). Once the trade or business requirement is satisfied, the issues are the same as those pertaining to a corporate taxpayer, that is, whether the loss is uncompensated, its amount, and the year in which it was sustained.[439] The scope of the term "trade or business" is the same as it is under Section 962(a), relating to the deduction of ordinary business expenses.

Losses sustained as a result of physical damage to business property are deductible from gross income in accordance wwith Section 165(a), as previously discussed. Hence, in the case of non-business property, the deduction is limited to losses resulting from fire, storm, shipwreck, or other casualty, or from theft. Where business property is concerned, however, the damage need not be traceable to one of these specific events. The technical definition of a "casualty," which has occasioned difficulty in connection with damage to non-business assets, is, therefore, largely unimportant in relation to business

property.

Regarding the amount of deductible loss, the Regulations follow the same rules applied to property held for personal use, except that if business property having an adjusted basis in excess of its market value is totally destroyed, the loss is the amount of the adjusted basis rather than the lower value.[440]

Section 267, IRC, provides that no deduction shall be allowed for losses from sales or exchanges of property (other than distributions in corporate liquidations) between persons within the relationship as follows: 1. Members of a family, such family membership being restricted to the taxpayer's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. 2) An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, 3) Two corporations, of which the same individual owns more than 50% if one corporation is a personal holding company. 4) A grantor and a fiduciary of the same trust. 5)A fiduciary of a trust and a fiduciary of another trust, if the same person is the grantor of both trusts. 6) A fiduciary and a beneficiary of the same trust. 7) A fiduciary of a trust and a corporation of which the trust or a grantor

of the trust owns more that 50%. 8) A person (an individual or an entity) and a tax-exempt organization (a charitable or an educational organization) controlled by such person, or, if such person is an individual, by the members of his family as defined in item 1, above.

For the purpose of determining in items, 2, 3, and 8 whether an individual owns more than 50% of the stock of a corporation, certain stock attribution or "constructive ownership" rules are applicable.[441] Stock owned by a corporation, partnership, estate or trust is considered to be owned proportionately by its shareholders, partners, or beneficiaries, stock owned by one partner is considered to be owned by another partner, provided that the latter also owns stock in the corporation; and stock owned by the members of an individual's family is deemed to be owned by the individual.[442]

The disallowance of loss occurs automatically under Section 267. It is immaterial whether a transaction between related taxpayers was bona fide in that it would have taken place without regard to tax consequences, or whether the consideration received by the seller was equal to, or even in excess of, the fair market value of the property sold.[443] Although the Section was possibly enacted with sales of corporate securities principally in view, it is applicable to the sale of any property and is not limited

to securities transactions.[444]

Loss is disallowed under Section 267 on a sale of property, whether direct or indirect, between related taxpayers. In McWilliams v. Commissioner,[445] the Supreme Court denied a loss deduction where a husband and wife bought and sold the same securities through a stock exchange at approximately the same price. The Court found that Section 267 was applicable even though the securities were sold to and purchased from independent unknown parties through the anonymous medium of the exchange.

Whether a "sale or exchange" has actually occurred within the meaning of the Section has also caused difficulty in some cases. In one decision,[446] the taxpayer's property was sold by local officials at public auction for delinquent taxes. It was purchased by a representative of the taxpayer who then conveyed the property to a corporation controlled by the taxpayer. Loss was allowed. Since the property was sold by the Government and the sale was involuntary on the part of the taxpayer. There was no indirect sale between the taxpayer and the purchasing corporation wherein the taxpayer owned more than 50%.

Where a corporation is organized to acquire the assets of an existing partnership, the stock of the corporation being held by the partners, any loss incurred in the trans-

action is disallowed.[447] This is the rule despite the view that, since a partnership, for some purposes, is treated as an entity separate from the individual partners, such loss should be regarded as loss of the partnership and not of the partners.

Section 267 does not affect the recognition of gains on sales between related taxpayers, even though disallowed losses are sustained in the same transaction. If both gains and losses are realized on the simultaneous sale of several properties, the gains and losses are separated. The gains are recognized, but the losses are disallowed.[448]

The buyer's basis for property acquired from a related seller is his cost and not the seller's basis. The result of this is to deny the buyer, in effect, the opportunity to deduct on a later sale of the property at a loss.[449] However, Section 267 (d) provides that if the buyer subsequently resells the property at a gain, the gain is recognized only to the extent that it exceeds the amount of the loss not previously allowed to the original seller.

Even where the transaction is technically outside the scope of Section 267, a loss may be disallowed if a transaction is not bona fide. In Higgins v. Smith,[450] an individual sold securities at a loss to his wholly owned corporation. Although the transaction took place prior to

the enactment of the forerunner of Section 267, the Court denied the taxpayer a deduction on the ground that no loss had been "sustained" within the meaning of a section corresponding to the Section 165 due to the taxpayer"s continued control of the securities through his stock ownership in the corporation.

Depending on the particular facts, a loss may be allowed on a transaction involving "unrelated" parties even though the same ultimate objective, if achieved by an alternate course, would have resulted in disallowance.[451] Thus, a loss was allowed in one instance where the taxpayer sold securities to his brother's son -in-law. Here, it was established that the taxpayer's brother gave his daughter the funds used for the purchase.[452]

Section 1091, IRC, provides for the disallowance of any loss incurred on a sale of stock or securities where, within a period beginning 30 days before and ending 30 days after the date of the sale, the taxpayer repurchases, or enters into a contract or option to repurchase, substantially identical stock or securities. Under the mentioned circumstances, the taxpayer's original investment is deemed to continue without interruption, or at least without material interruption, and, hence, the loss purportedly sustained is regarded as resulting from a "wash sale" and

is not recognized by the Code.[353] Section 1091 is considered as an "exclusive" provision, so that if a bona fide sale and repurchase take place outside the 61 day statutory period, any loss incurred on the sale will be deductible under Section 165.[454]

Under Section 1091(d), the repurchased stock or securities obtain a basis equal to the basis of the property sold, so that the loss deduction is postponed and not permanently disallowed. Likewise, the holding period of the property sold is added to the holding period of the repurchase stock or securities to determine whether any capital gain or loss subsequently realized is long-term or short-term.[455]

As to what constitutes "substantially identical" stock or securities, it has been held that an approximation to identity, and not mere similarity, is required by the statute.[456] A non-voting common stock is not substantially identical with voting common stock of the same corporation.[457] Nevertheless, substantial identity has been found between Series A and Series B debentures of the same company where both series and the same maturity date and interest rates, the only differences being the dates of issuance and the amounts to be redeemed annually.[458]

Finally, Section 1091 disallows only losses and not

gains. Hence, a taxpayer who has realized capital losses in excess of capital gains is free to carryout a wash sale of stock or securities at a gain which will be offset by the losses, and thereby secure an increase in the basis of the wash sale stock to current values.[459]

In the United States, as in France, capital losses are either short-or long-term.

Under Section 1222 (6), if the assets were held for more than six months, the capital loss is long-term. If the assets were held for six months or less, the capital loss is short-term.

Section 1211, IRC, prescribes the limitations on the allowance of capital losses.

With respect to individuals, capital losses in excess of capital gains are only "allowed" to offset up to $1,000 of ordinary income. In accordance with Section 1212, IRC, the losses not utilized in any one year may be carried forward, for five years as a short-term capital loss, by applying the same against capital gains in each of those years. After the capital gains are exhausted, the balance of the short-term capital losses can be applied against $1,000 of ordinary income. There is no percentage limitation on the amount of a capital loss which may enter into the computation of taxable income, despite the elimination

of 50% of long-term gains through the special deduction.[460] However, as stated above, capital losses must first offset capital gains, taking the gains into account at 100% before they can offset ordinary income.[461]

In the case of corporations, capital losses are allowed only to the extent of capital gains, with a five-year carry-over of the excess losses.[462] Hence, the opportunity to offset $1,000 of ordinary income for the taxable year and each of the five succeeding years is not available to corporations.

Section 165(g)(1), IRC, provides that, if a corporate security which is a capital asset becomes worthless during the taxable year, the loss will be treated as if it had arisen from the sale or exchange of a capital asset on the last day of the taxable year. The loss is thus restricted to offsetting capital gains plus $1,000 or ordinary income over a six-year period. The term "security" means bonds, debentures, and other evidence of indebtedness issued by a corporation or a governmental unit with interest coupons or in registered form, as well as corporate stock.[463] The treatment of worthless securities is generally equivalent to the treatment of non-business bad debts except that, in the case of worthless securities, the capital loss will almost always be long-term.

As in the case of bad debts, the problem of establishing the year in which a security becomes worthless frequently causes difficulty. It has been judicially declared that the year in which the security becomes worthless is not fixed by a subjective test turning on the reasonableness of the taxpayer's opinion as to worthlessness. It is determined by a practical approach under which all pertinent facts and circumstances are considered, regardless of their subjective or objective nature.[464]

PHILIPPINES

In the Philippines, under Section 30(d), NIRC, the requisites for deductibility of losses are: 1) the losses must be actually sustained during the taxable year; and, 2)the losses must not be compensated for by insurance or otherwise.

Loss is deductible only in the taxable year it is actually sustained. However, if it is compensable by insurance or otherwise, deduction for the loss suffered is postponed to a subsequent year, which, to be precise, is that year in which it appears that no compensation at all can be had, or that there is a remaining or net loss.[465]

On the other hand, the rule is that loss deduction will be denied if there is a measurable right to compensation for the loss with ultimate collection reasonably

clear. So where there is reasonable ground for reimbursement, the taxpayer must seek his redress and may not secure a loss deduction until he establishes that no recovery may be had. In other words, the taxpayer must exhaust his remedies first to reduce his loss.[466]

The burden of proving the losses is upon the taxpayer. The deduction for losses is confined to persons sustaining them. They are personal to them and not transferable.

Losses must be evidenced by closed, and completed transactions.

The rules regarding the foregoing aspects are similar to those in the United States.

The kinds of losses deductible are: 1) losses incurred in trade or business; 2) losses in any transaction entered into for profit, though not connected with trade or business; and, (3) losses of property arising from fire, storms, shipwreck, or other casualty, or from robbery, theft or embezzlement.[467]

Losses which are deductible with certain limitations are as follows: a. Wagering transactions - to the extent of the gains arising from such transactions. b. Capital losses - to the extent of capital gains only. This will be discussed later. c. Losses from wash sales. This will also be considered later.

Losses from illegal transactions are not deductible.[468] The question whether the amount of ₱5,000 confiscated in a foreign country by customs authorities for violation of their fiscal regulations could be deducted by a Filipino taxpayer on his income tax return, in accordance with Section 30(d), NIRC, was submitted before the Bureau of Internal Revenue for decision. The Bureau ruled that, since the loss did not qualify under casualty losses and no proof was adduced to show that it was a loss in a transaction entered into for profit, it was held that loss sustained in violation of foreign customs laws could not be deducted from income.[469]

Losses from sales or exchange of property between: (1) members of a family, (2) an individual and a corporation, more than 50% in value of the outstanding stock is owned by the individual, (3) two corporations more than 50%of the value of the outstanding stock of each is owned by the same individual if either one of such corporations with respect to the taxable year preceeding the sale or exchange was a personal holding company (4) a grantor and a fiduciary or any trust, (5) a fiduciary of a trust and fiduciary of another trust if the grantor of each trust is the same person, (6) between a fiduciary of a trust and a beneficiary of another trust, and (7) losses from operating a

farm for recreation or pleasure, are also not deductible.[470] The regulations and jurisprudence on the matter are similar to those in the United States.

Furthermore, under Section 35(c), NIRC, the gain or loss from a corporate merger or consolidation is not recognized as against the absorbed corporation or as against its stockholders and security-holders. The provision assumes the presence of transactions where the gain or loss, if any, should not be recognized for income tax purposes, because they merely involve a modification of the form of interest of the taxpayer or because they affect nothing more than the form of the same business.

Moreover, Section 33(a), NIRC, prohibits the deduction by an individual, other than a dealer in securities with respect to a transaction made in the ordinary course of the business of such dealer, of a loss sustained by him from any sale or other disposition of shares of stock or securities, where it appears that within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date the taxpayer has acquired or has entered into a contract or option so to acquire substantially identical stock or securities. The quoted provision is identical to that found in the United States involving the same question.

With respect to capital losses, if a capital loss is sustained, such loss is not deductible from the taxpayer's other income but may be offset only against any capital gain he has realized.[471] If the amount of the net capital loss for a taxable year is larger than the capital gain, then a taxpayer other than a corporation may carry over the loss to the succeeding taxable year in an amount not in excess of the net income for such year, and offset the said capital loss against the capital gain of the succeeding year.

However, the rule in the United States, allowing individuals to deduct capital losses from ordinary gains after exhausting capital gains does not exist in the Philippines. Moreover, in the Philippines, the carry over privilege is applicable only to individuals and only up to the next taxable year.

CANADA

In Canada, Section 27 (1) (e), allows the deduction of ordinary business losses.

Losses to be deductible must be those arising from business. Thus, the loss sustained when a Canadian subsidiary repaid a loan from a U.S. parent company was held deductible because the debt was a result of trading operations.[472] The losses of a company in the business of

buying and selling securities were also held to be deductible even if the company was a trust company in name, though not in fact.[473] Likewise, a loss sustained by a mining stock underwriting company on a negotiable note since the underwriting company was in the securities business was held to be deductible.[474]

In the Solloway Case,[475] it was held that a company liable to taxation on all profits realized from ventures entered into as part of its business, may deduct any losses incurred in connection with the same ventures from the company's profits from any other source.

However, in Highwood Sarcee Oils Ltd. v. M.N.R.,[476] a company in the business of oil exploration invested in shares of another oil exploration company and thereby suffered a loss. The loss was held not to be deductible because the taxpayer was not in the business of buying and selling oil shares.

Where a business suffers a loss by fire or theft the normal procedure is to claim such loss as an ordinary expense of doing business.[477] This procedure may be followed in losses by theft whether the loss is occasioned by an outside thief or by an employee's theft.[478] The rulings of the Department on this questions vary with the facts of each case: If the loss is unusual and large, the

Department is inclined to question it as a routine cost of doing business.[479] If the articles or cash stolen or destroyed belong to the capital equipment of the business, such as office equipment and cash raised for capital purposes, the Department considers the replacement expense as a capital loss and therefore does not allow it as deductible expense of the business.[480] On the other hand, losses by fire or theft of inventory or cash collected in the day's business representing proceeds of sales are considered deductible losses incurred in the ordinary course of doing business.[481]

A personal loss as distinguished from a business loss is not deductible. Thus, in the Orban Case,[482] losses through loans to friends by a taxpayer who was not a professional moneylender were held non-deductible.

It should be noted that if a company stops operations for a year and resumes business under the control of different persons, no deduction of previous losses is allowed.

In Canada, since capital gains are not taxable, capital losses are also not deductible. In the Northern Sales Ltd. Case,[483] a company suffered a foreign exchange loss in repaying a long-term loan from an affiliated U.S. company. The loss was held to be a non-deductible capital loss. However, its foreign exchange loss in that same year

from its day-to-day trading in the world market was considered a deductible expense. It must be mentioned that if securities are held so long that the law would regard them as having become investments, a loss on the sale of the same would be a non-deductible capital loss.[484]

It should be emphasized that there is a pending proposal before the Canadian Parliament with respect to the deductibility of capital losses.[485] The proposal is, of course, dependent upon the approval of the plan to bring into income one-half of the capital gains in every taxable year.[486] The recommendation is that one-half of the capital losses should also be taken into account and be deductible without limit from the taxable half of the capital gains realized in the same year.[487] If in the year, the deductible capital losses exceed taxable capital gains, an additional $1,000 of deductible losses should be deductible from other income.[488]

In connection with closely-held corporations, if one-half of the gains on the sale of shares are taxed, the recommendation is to allow the deduction of one-half of the losses.[489]

8. Depletion

FRANCE

In France, there are two types of depletion allo-

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wances. They are the cost depletion allowance and the percentage depletion allowance.

With respect to cost depletion, it has very limited application because a landowner has no effective way to exercise his property right over subsurface minerals, since all power of disposition over those minerals is vested in the government. No mine may be exploited except under a concession granted by the government and approved by the Council of State.[490] A firm exploiting a mineral or oil deposit generally owns no interest in the deposit whose "cost" it may deplete.[491] The rules on cost depletion, thus, apply only to surface deposits exploited as quarries, and pits and peat bogs.[492] For said surface deposits, an annual depletion deduction based on cost is permitted. As a rule, "the cost dpletion allowance must reflect the decline in the mineral quantity suffered by the deposit as a consequence of exploitation."[493] Normally, "the amount of the annual deduction is calculated on the basis of tonnage extracted during the year."[494] Moreover once "the cost of the deposit has been recovered, no further depletion allowance is available."[495]

The percentage depletion system in France was modelled after that of the United States and was adopted in 1953.

Only enterprises actually engaging in (1) exploration

for, or production of, oil and gas, or (2) extraction of one of the solid minerals listed... are entitled to the percentage depeletion allowance."[496]

In connection with the computation of the annual percentage depletion allowance, oil or gas producers, at their option, "may deduct from taxable income a depletion allowance which may not exceed the higher of (1) 27.5% of the sales of "merchantable products' extracted from their wells ... or (2) 50% of the net income before depletion, derived from production (CGI Art. 39 ter)."[497] In case of solid minerals, the first limitation is reduced to 15% of sales.[498]

It should be underscored that only operations yielding income taxable in France are taken into account in calculating the limitations of 27.5% or 15% of sales and 50% of net income.[499] The reason for this is that French corporations, as already explained, are, generally, not subject to corporate income tax on income derived from a permanent establishment outside France.

UNITED STATES

As in France, in the United States, the annual depletion allowance is intended to compensate the taxpayer for the exhaustion of the mineral contents of his property. The allowance is either a cost allowance or a percentage allowance.

The cost depletion allowance pursuant to Section 61(a), IRC, is designed to apportion the taxpayer's cost basis over the estimated life of the mineral deposit in proportion to the number of units of minerals sold during the taxable year. In accordance with Section 612, IRC, the basis of the property for cost depletion purposes, determined under Section 1011, is the same as its basis for determining gain on a sale of the property, normally the taxpayer's actual cost. This figure is first divided by the number of units of the mineral remaining at the beginning of the taxable year, such as tons of ore or barrels of oil, estimated in accordance with methods current in the industry.[500] The resulting basis per unit is then multiplied by the number of units sold during the taxable year in order to obtain the depletion deduction for the year.[501]

Under Section 613, IRC, the percentage depletion may be taken as an alternative to cost depletion with respect to any mineral, including oil and gas. Since the annual depletion allowance may not in any event be less than it would be if computed under cost depletion, the taxpayer must annually compute depletion under both methods and deduct the larger figure.

The annual deduction based on percentage depletion is computed at a flat percentage of the "gross income"

derived from the mineral property. In case the extracted crude mineral product is processed by the taxpayer prior to sale, "gross income" for percentage depletion purposes is generally calculated by multiplying the quantity of the crude product by the market price for the crude product.[502]

The annual deduction under the percentage depletion system is limited to a maximum of 50% of the "taxable income" from the property.[503] Taxable income is computed by deducting from gross income all allowable expenses, other than depletion, which are properly allocable to the property.[504] Intangible drilling costs which the taxpayer has elected to treat as current expenses are also deducted for this purpose.[505] The limitation precludes the oil and gas taxpayer from deducting the full 27.5% of gross income for depletion as to any "property" on which applicable expenses are in excess of 45% of gross income.[506]

The IRC provisions for elective aggregations of properties for taxable income calculations in effect permit the taxpayer to obtain full percentage depletion as to his gross income from low net income properties by grouping them with high net income properties.[507]

The term "property", as defined in Section 614(a), IRC, means each separate interest owned in each mineral deposit in each separate tract of land. However, aggrega-

tions are allowed according to a special rule for "operating mineral interests."[508] There is a special rule for "non-operating mineral interests."[509]

The statutory percentage depletion rates are provided for under Section 613(b). It applies to oil and other solid minerals enumerated under Section 613(b).

PHILIPPINES

In the Philippines, the depletion allowance is authorized under Section 30(g), NIRC. The cost of depletion alowance is not utilized in the Philippines. Only the percentage depletion allowance is used. To be entitled to claim dpeletion allowance, the taxpayer must have an economic interest in the property..To acquire an economic interest, the taxpayer must have a capital investment and nor a mere economic advantage.[510] Depletion allowances are designed to permit tax-free recovery of capital investments.[511]

The basis of depletion allowances is the gross income from the mining property after deducting rentals and royalties. The total percentage depletion should not exceed 50% of the net income.[512]

The rates of depletion are 27 ½%, 23% and 15% depending on the kind of mineral mined.[513]

CANADA

In Canada, the authority for deducting allowances for depletion is found in Section 11(1)(b), ITA, and is distinct from the depreciation allowance under Section 11(1)(a), based on capital cost.

Section 11(1)(b) provides that "notwithstanding paragraphs (a), (b) and (h) of subsection (1) of section 12, the following amounts may be deducted in computing the income of a taxpayer for a taxation year ... (b) such amount as an allowance in respect of an oil or gas well, mine or timber limit, if any, as is allowed to the taxpayer by Regulation."

While capital cost allowance under Section 11(1)(a) may be had for timber limits and certain industrial mineral mines, the depletion allowance in accordance with Section (11)(1)(b) for the mentioned items is not related to capital cost.

Unlike France and the United States, in Canada the depletion allowance cannot be computed on a percentage basis.

9. Taxes

FRANCE

In France, under Article 39-1-4°, CGI, it is provided that taxes levied on an enterprise in the course of a fiscal period are deductible from income for that period.

Specifically, a business enterprise can deduct the

following taxes: 1) employer's payroll tax; 2) apprenticeship tax on employer's; 3) local business tax; 4) local tax on improved land; 5) certain registration taxes levied on movements of capital or transfers of property; 6) differential tax on automobiles; 7) special tax on luxury cars; 8) tax on employers who fail to make certain required housing investments; 9) social security charges levied on employers; 10) to the extent that the tax credit is barred by one of the applicable restrictions, the value added tax borne by an enterprise on its purchases; 11) tax on services borne by a business enterprise on services rendered to it; and, 12) sales, excise, and indirect taxes that a business may be required to pay in the course of its operations.[514]

The rules regarding taxes paid as an item of deduction are as follows: "As a general rule, a tax otherwise deductible from business income may be deducted only if the payor is the person legally liable for the tax under the Tax Code. A tax that a firm chooses to pay on behalf of a third party from whom it is due is generally not deductible as a tax. Such a tax may be deductible, however, if it is in effect a supplement to a payment otherwise deductible. A firm that has borrowed money and agreed to assume the obligation of withholding tax on the interest

may deduct the amount of the tax from its business income, but as additional interest rather than tax proper. A firm that agrees to assume taxes normally due from the seller on the purchase of a capital asset may not deduct the taxes; these taxes are a supplement to a non-deductible capital expenditure."[515]

However, there are exceptions to the rule of the deductibility of taxes. Taxes paid which are not deductible are the following: 1) the corporation or individual income tax; 2) the 60% tax on inventory; 3) the 3% tax on revaluation reserves; 4) the 12% tax on distribution of revaluation reserves; and, 5) the annual tax on passenger cars owned by corporations.[516]

France gives no credit against French taxes for foreign taxes paid. If unilateral relief from international double taxation is necessary, it is accomplished by exemption of the income in question from French taxation.[517] Thus, corporations are not taxed on income from business activity abroad. If income is taxable in France, the foreign tax paid thereon is not creditable although deductible.[518] The foreign tax deduction is available only with respect to taxes paid in countries having treaties with France on the matter.

UNITED STATES

In the United States, with the general exception of federal taxes, all taxes paid or accrued during the taxable year may be deducted from gross income. Section 164(a), IRC, allows the deduction of any expenditure, unless specifically excepted, which qualifies as a "tax".

Almost all taxes imposed by state and local governments, such a s property taxes, excise taxes, sales taxes, and income taxes, are deductible in computing taxable income for federal tax purposes.[519]

Section 164(b), IRC, prohibits the deduction as "taxes" of federal income taxes, federal import duties, federal import duties, federal excise and stamp taxes, and federal and state estate, inheritance, legacy, succession, and gift taxes. The fact that most federal taxes are not deductible as "taxes" under Section 164 does not, however, prevent the deduction of many federal tax items, when incurred by a corporation or by an individual in the conduct of trade or business, as ordinary and necessary business expenses under Section 162(a). Consequently, federal import duties, federal stamp taxes, and federal excise of all kinds may be allowed as business expenses, or as part of the cost of goods sold if they are incurred in connection with the purchase or production of inventory.[520] Like-

wise, although collected as an excise tax, a contribution by an employer under the social security program is fully deductible as a business expense.[521] No deduction is permitted for federal income taxes.

To the extent that taxes may be deducted not as "taxes" but as business expenses, the limitations of Section 162(a) are generally applicable.

Under Section 1.164-3 of the Regulations, federal taxes incurred in connection with capital expenditures, such as the acquisition of depreciable business assets, are apparently required to be capitalized and may be recovered only through amortization over the life of the property acquired. The same restriction does not apply to deductible state and local taxes. Hence, a state sales tax which is imposed directly upon the purchaser of certain goods may be deducted by the purchaser as a "tax," even though the asset purchased is a capital item.[522]

Income taxes paid to a foreign country may be deducted under Section 164, unless the taxpayer elects to credit such taxes against the United States income tax. Where foreign source income is subject to both foreign and United States income taxes, the general effect of the credit is to treat the foreign taxes paid on this income as part payment of the United States tax.[523] The credit gives a

full offset against United States tax for a dollar paid in foreign taxes. The credit is, therefore, more valuable than the deduction for foreign taxes allowed by Section 164, since the deduction, in offsetting the foreign income tax dollar against gross income and not against tax, gives the foreign tax a value to the taxpayer equal only to the United States marginal tax applicable to the gross income thus offset.[524] Only foreign income taxes are eligible for the credit.[525] Taxpayers who incur other types of foreign taxes are restricted to the deduction under Section 164.[526] The foreign income tax credit or deduction is available only with respect to taxes paid in countries having treaties with the United States regarding the matter or on the basis of reciprocity.

PHILIPPINES

In the Philippines, Section 30(c), NIRC, provides that all taxes paid or accrued during the taxable year are deductible except: (a) income tax; (b) income war profits, and excess profits taxes imposed by the authority of any foreign country (but deduction shall be allowed in case the taxpayer does not signify in his return his desire to have to any extent the benefits pertaining to credit for taxes of foreign countries); (c) estate, inheritance and gift taxes; and, (d) taxes assessed against local benefits

of a kind tending to increase the value of the property assessed.

The word "taxes" means tax proper and does not include fines and penalties incident to delinquency such as surcharge and compromise.[527] Taxes are deductible as such only by the person upon whom they are imposed. Thus, the merchants' sales tax imposed by law upon sales is not deductible by the individual purchaser even though the tax may be billed to him as a separate item.[528]

Regarding foreign tax credits, as to resident aliens, they are only available with respect to taxes paid in countries allowing Filipino citizens residing in said countries a similar privilege to credit. As in the U.S., citizens and domestic corporations are entitled to credit even in the absence of a treaty or reciprocal arrangements regarding the matter.

CANADA

In Canada, it is clear that Dominion income tax payments cannot be deducted in computing the taxpayer's income.

Other forms of taxes paid for the purpose of earning income are deductible as a business expense. However, in York Gears Ltd. v. M.N.R.,[529] it was held that where municipal taxes were paid on surplus land not used in a business but held for business expansion they represented

expenditure on capital account. It should be noted that in this case expansion had been abandoned and the excess land sold.

Unlike the Philippines and the United States, in Canada, under Section 41, ITA, taxes paid by an individual resident in Canada or a resident corporation carrying on business in a foreign country are deductible but not creditable in computing income. However, in Roenish v. M.N.R.,[530] where the income tax assumed the form of a personal obligation of the taxpayer, the income tax of another jurisdiction was held not deductible.

With respect to the deductibility of income taxes paid in foreign countries, unlike France, in Canada, it is available even with respect to taxes paid in countries having no treaties with Canada on the matter.

It should be noted that there is now a proposal pending before the Canadian parliament to make the credit for corporate tax applicable only to corporations incorporated in Canada after a five-year transitional period.[531]

IV. DEPRECIATION AND AMORTIZATION

FRANCE

In France, Article 39-1-2°, CGI, expressly allows the deduction of depreciation in the determination of actual net income from business. It also provides that depreciation claimed for tax purposes must coincide with book depreciation.

As was explained earlier, capital expenditures which have as their counterpart the addition of a fixed asset to the net worth of the firm are not, as a rule, deductible. However, capital assets decline in value as the result of use, obsolescence, and the passage of time. The depreciation deduction is "designed to take account of this decline in value and to permit the recovery, tax free, of the cost involved in the utilization of the asset."[1]

In accordance with the 1959 tax reform the declining-balance system of depreciation must be used for depreciating machinery and equipment.[2] With respect to buildings, the straight-line depreciation system must be used.[3] There is, however, an exception. To "encourage investment in hotels, and as an incentive to the tourist industry, the declining-balance depreciation was made available for hotel buildings and hotel equipment."[4]

Let us first discuss the straight-line depreciation

system. Under this method, "a business taxpayer may deduct each year a constant percentage of the cost of acquisition of each depreciable asset that it owns."[5] The asset's anticipated useful life is the basis of the percentage in accordance with the usage of each industry or trade.[6] It is explained that depreciation "should be deducted at a constant rate, admittedly more or less approximate, so that at the end of the asset's anticipated life the firm will have recovered, free of tax, the original cost of the asset".[7] (Underscoring supplied.)

Under Article 39-1-2°, CGI, depreciation deductions deferred in a loss year are not lost but may be taken in later years, in which the taxpayer shows a profit after deduction of normal depreciation for the year, and after deduction of loss carry-overs to which the taxpayer may be entitled.[8]

With respect to profit years, some deferred deductions are also allowed. There are two variations possible, as follows:

> "First the depreciation deferred in a profit year may be less than the amount of income reported for that year; deduction of depreciation in that year would not convert the year from a profit year to a loss year. In this case, the amount deferred may not be taken in addition to normal depreciation in later years during the anticipated useful life of the machinery. The amount deferred may be taken only after expiration of the normal deprecia-

tion period of the asset.

"Second, the depreciation deferred in a profit year may be more than the amount of income reported for the year; deduction of depreciation rather than deferral in that year would convert the year from a profit year, or years, in addition to normal depreciation for those years. The balance, that is, the amount of deferred depreciation equal to the profit reported for the deferral year, is deductible only after the expiration of the normal depreciation period."[9]

Next, we have the declining-balance system of depreciation. There are two steps under this method. It is explained thiswise: "First, a straight-line-depreciation rate is determined for the asset by dividing the figure 100 by the number of years of anticipated useful life (CGI Ann. II, Art. 0025-1). Second, this rate is multiplied by a coefficient that varies with anticipated life. The coefficients are 1.5 for assets whose anticipated life is five or six years, and 2 for assets whose anticipated life is five or six years, and 2.5 for assets whose anticipated life is longer than six years (CGI Ann. II, Art. 0025-2). The result is the declining-balance rate."[10]

In a loss year, a taxpayer who defers depreciation may carry forward the amount of depreciation deferred and subtract it in the first year, or years, in which his profit, after deduction of the amount of depreciation normally applicable to that year, or years, is sufficient to absorb

the deferred amount.[11]

In a profit year, the deferral is explained in this manner:

> "First, the amount of depreciation that would have been deductible in that year under the straight-line depreciation method must be ascertained. The straight-line figure is the minimum that the taxpayer should deduct in any particular year; the amount is considered to be an expense of that year .... If the depreciation taken in the profit year in question is greater than this straight-line figure..., the only result is that the residual value at the end of that year is higher than it would otherwise have been. In subsequent years, the taxpayer merely applies the ordinary declining-balance rates to his residual value. In those years, he may also defer depreciation if he wishes."[12]

In France, the problem of amortization could be divided into the amortization of intangibles and the amortization of shares in special companies.

With respect to intangibles, the cost of patent is usually deductible in equal annual amount's over its lifetime.[13] By cost is meant the expenses incurred for acquisition if the patent was purchased from a third party.[14] Where the patent is developed by the taxpayer, in accordance with C.E. 23 October 1931, No. 18, 339, if an unusual event, such as obsolescence of an invention due to technical progress, creates an abnormal decline in the worth of the patent during its lifetime, a supplementary deduction may be taken to reflect the reduced actual value

of the cost of its development.

Another intangible is goodwill. The cost of acquiring business goodwill from a third party is ordinarily not depreciable. Nevertheless, if some abnormal occurrence causes "an effective and permanent decline in the value of goodwill, a deduction may be taken in recognition of the loss."[15] Thus, in C.E. 8 January, 1932, No. 4,672, a construction company was allowed deduction for the decline in the value of its goodwill after the permanent decline in sales and profits due to the slackening of business in formerly devastated areas. It should be noted that the criterion is the permanent decline in sales or profits. A mere temporary decline will not warrant a write down of goodwill.

Trade-mark is regarded as an element of goodwill. Hence, the expenses in the acquisition of a trade-mark, the validity of which is not limited in time, is not deductible. In order that the cost of trademark may be considered deductible, it is necessary that the value of all elements constituting goodwill decreases.[16]

Regarding amortization of shares in special companies, a 1958 ordinance designed to encourage research in France provided that "business enterprises acquiring shares or interests in entities, public or private,

engaged in research and approved for the purpose by the Minister of Finance and Economic Affairs could, in the year of investment, write down the investment by 50% and take a corresponding deduction from taxable income.[17] Another ordinance, in 1958, provided the same benefits with respect to the purchase of shares of certain approved companies engaged in housing construction.[18] In addition, another ordinance gave business enterprises the choice to receive dividends taxfree from the housing construction companies in lieu of the 50% deduction.[19]

As a result of the common market, in 1959, an ordinance was adopted to encourage the grouping of small firms in order to increase productivity and to lower prices. The participating firms "received an immediate 100% write-off, deductible from income, of the amount of their participation.[20]

UNITED STATES

In the United States, Section 167, IRC, permits a taxpayer to deduct, as an ordinary business expense, a "reasonable allowance" for the exhaustion or obsolescence of property" used in the trade or business, or ... held for the production of income."

The problems pertaining to depreciation deduction are: (1) the determination of whether the particular

asset is depreciable; (2) the determination of the amount of the taxpayer's investment in the asset; and (3) the determination of the rate of depreciation.[21] The last problem involves two subsidiary issues, namely, the determination of the asset's estimated useful life and its salvage value, and the determination of the method of apportioning the taxpayer's investment over the useful life.[22]

The deduction for depreciation is allowed only for property "used in the trade or business, or ... held for the production of income" in accordance with Section 167 (a), IRC. In the case of tangible property, the allowance applies only to such properties subject to exhaustion, wear and tear, and obsolescence.[23] Depreciation is not allowed for inventories or stock in trade. The allowance also does not apply to land, except for the improvements which may be added to it.

Buildings, machinery and equipment, vehicles, office furniture, and other assets of a relatively permanent nature are among the principal types of business property for which depreciation may be claimed.[24] Property devoted to personal use, such as a residence which the taxpayer occupies himself or an automobile used entirely for pleasure, is not depreciable.[25]

The depreciation deduction is allowed only to the

person or persons with a capital investment in the property. While a lessor of a building is normally entitled to depreciation, a lessor who leases property under a lease requiring that the property is to be maintained by the lessee and that its equivalent value is to be returned to the lessor at the end of the lease is not entitled to depreciation for the duration of the lease.[26] Further, since a taxpayer, to be entitled to a deduction, must have made a capital investment, a lessee is not entitled to depreciation, except with respect to actual capital expenditures made by him during the lease.[27] In this event, the period for depreciation is generally the life of the improvement made by the lessee or the remaining term of the lease, whichever is shorter.[28]

The total depreciation deductions allowed over the useful life of a depreciable asset may not exceed the original cost of the asset less its estimated salvage value.[29] The original cost of the asset is referred to as its "basis". It is determined for depreciation purposes in the same manner as it is for purposes of computing gain on the sale or other disposition of the asset.[30] The basis of the asset, originally, its historic cost, is subsequently adjusted to take into account depreciation deductions.[31]

Section 1.167 (b) - 0(a) of the Regulations provides

that "any reasonable and consistently applied method of computing depreciation may be used or continued in use under Section 167". However, once a method of depreciation is adopted by the taxpayer with respect to a particular asset, it can be changed only with the consent of the Commissioner, except that a change from the declining balance to the straight-line method is allowed without consent.[32]

Section 167 (b) permits, but does not limit the taxpayer to, the use of any of the following methods of depreciation for taxable years ending after 31 December 1953: (1) the straight-line method; (2) the double declining balance method; (3) the sum of the years-digits method; or (4) any other consistent method of depreciation.

These methods, other than the straight-line method, are applicable only to tangible property having a useful life of three or more years. Further, they are applicable only to property acquired after 31 December 1953, the original use of which commences with the taxpayer after that date, and to the construction, reconstruction, or erection of property, by or for the taxpayer, which is completed after the date.

Under the straight-line method, "the annual depreciation allowance is computed by dividing the cost of the asset, less its estimated salvage value, by its estimated

useful life."[33]

The declining balance method is described as follows: "... a uniform rate of recovery is applied each year to the unrecovered cost of the property, without any reduction for salvage value. Section 167(b)(2), IRC, provides that the declining balance rate may be as much as, but may not exceed, twice the rate computed under the straight-line method. Twice the straight-line rate is almost always used, except that a 150% declining balance rate is frequently applied to used property to which the double declining balance method cannot be applied. Hence, the method is popularly referred to as the double declining balance method. Since the basis of the asset is always reduced by prior depreciation deductions, the rate is applied to a constantly declining basis. Ths declining basis is equal to the unrecovered cost of the asset without reduction for estimated salvage. In the usual case, the declining balance method leaves an undepreciated balance of some 10 to 13% of original cost at the end of the asset's estimated useful life, which may be an unrealistically high salvage value. In order to avoid this unattractive aspect of the declining balance method, Section 167(3) permits a taxpayer to use the declining balance method during the first part of the asset's useful life and then, at any time,

change over to the straight-line method, even though this permits deductions in the latter part of the asset's life in excess of those which would be obtained under strict application of the declining balance method. The remaining cost (less estimated salvage) at the time of the change to the straight-line method is then recovered in equal annual amounts over the remaining useful life of the asset."[34]

The sum of the years-digits methods is described as follows: "... the annual allowance is computed by applying a changing fraction to the cost of the asset less estimated salvage value. Thus, cost is constant, as under the straight-line method, but the rate varies. The rate for any one year is a fraction whose numerator is the remaining years of useful life (including the current year), and whose denominator is the sum of the numbers (digits) of the successive years of the asset's initial useful life."[35]

Section 179, IRC, relating to the additional First-Year Depreciation method, was specifically designed to promote the development of small business. Under this Section, a taxpayer, other than a trust, may choose, with respect to Section 179 property to include as part of the "reasonable allowance" for depreciation permitted by Section 167(a), IRC, an additional 20% of the cost of such property for the first taxable year for which a de-

preciation deduction is allowable. Nevertheless, the additional depreciation is available only to the extent of an aggregate cost of $10,000 per taxpayer, or $20,000 in the case of a joint husband and wife return.[36]

"Section 179 property" means any depreciable tangible personal property, new or used, acquired by purchase after 31 December 1957, and having an estimated useful life of six years or more."[37] If property is "acquired by trading in old property and paying a cash difference, then although the basis of the newly acquired sproperty is the remaining cost of the old property plus the cash paid, only the cash paid qualifies for the additional first-year allowance."[38]

In addition to the above discussed methods, Section 167(b)(4) permits a taxpayer to use any other reasonable and consistent method of depreciation,provided that the method used does not produce, having the first two thirds of the asset's useful life, accumulated allowances in excess of those that would have resulted from the use of the declining balance method.

Other permitted methods are: a) the 150% declining balance method, under which the declining balance method is used with the rate limited to 150% of the applicable straight line rate; b) the unit-of-production method, particularly applicable with respect to assets used in the

exploitation of natural resources, under which the annual depreciation allowance is computed on the basis of units produced, irrespective of the lapse of time; and, c) the retirement method, used chiefly by railroads, under which, in lieu of an annual depreciation charge, a deduction is allowed for the cost (less net salvage proceeds) of assets when they are actually retired from use.[39]

Section 47, IRC, contains a "recapture" provision which adjusts the credit previously allowed on a property in cases where the actual useful life of the property proves to be shorter than the useful life originally estimated. The adjustment is made by increasing the taxpayer's tax liability for the year in which the property is sold, rather than by increasing the tax liability for the year in which the credit was first earned.[40]

If property is shifted from a business to a personal use, or is transferred for use outside the United States, before the end of its estimated useful life, the recapture provision will come into play.[41] However, the recapture rule does not apply where property is transferred as a result of death, nor does it apply where property is transferred in certain corporate organizations or in other changes in the form of doing business, as when a sole proprietor transfers his assets to his wholly-owned cor-

poration.[42] After a change in business form, however, the recapture provision is applicable if the new business entity disposes of any of the property on which a credit was allowed before the end of its estimated useful life.[43]

It should be noted that, in France, there is no "recapture" provision.

In accordance with Section 167 (a), IRC, intangible assets having a limited useful life, such as patents and copyrights, also qualify for an allowance for depreciation. This is referred to as "amortization."

In the Associated Patentees, Inc. case,[44] the cost of patents to the taxpayer was based on income received by the taxpayer from the patents each year. As the total cost could not be determind until the termination of the life of the patents, the taxpayer was allowed to write off fully, as depreciation, each year"s investment since that was the portion of the total cost of the patents which was attributable to the income earned from the patents in that year.

Intangible assets of unlimited useful life are not depreciable.[45] Their cost is taken into account for tax purposes only when the asset is sold, or when it is abandoned, as on the termination of the business in which the asset is employed.[46]

The cost of acquiring goodwill is not recoverable through depreciation. The theory is that the goodwill continues to be of value as long as the taxpayer remains in business. The cost of acquiring a license or permit of indefinite duration is also a non-depreciable intangible asset.[47] Hence, in a case, where a taxpayer paid $8,000 to another licensee for a liquor license renewable annually at a fee of $750, the excess payment resulting from the limited number of licenses, the taxpayer was required to treat the excess as a capital expenditure which was not depreciable since, under local practice, the renewal privilege would continue as long as the taxpayer desired to renew.[48]

Section 177, IRC, permits a taxpayer to elect deferred expense treatment for expenditures, such as legal and registration fees, incurred in the acquisition or defense of a trademark or tradename. If the election is made, the expenditures may be amortized over a period of not less than 60 months.[49] If election is not made, the expenditures would apparently be treated as a non-depreciable capital item owing to the indefinite useful life of the assets.[50]

Unlike in France, there is no provision with respect to the amortization of the compnay shares in the United

States.

PHILIPPINES

In the Philippines, Section 30 (f), NIRC, allows a reasonable allowance for deterioration of property out of its not being used. When the allowance equals the capital invested by the taxpayer no further allowance is to be made.

As in France and the United States, the necessity for depreciation allowance arises from the fact that certain properties used in business gradually approach a point where their usefulnees are exhausted.

As in the United States the allowance does not apply to inventories or to stock in trade, nor to land apart from the improvements, or physical development added to it. It does not also apply to bodies of mineral which through the process of removal suffer depletion. In this regard, the rule in the United States is the same.

There are certain basic conditions precedent to the allowance for depreciation.

Firstly, there must be an acquisition by the taxpayer claiming depreciation resulting in some financial and proprietary interest. The test is whether the claimant to depreciation is in such a position as to suffer an economic loss as the result of the decrease in value of the

property due to depreciation.[51] The basic essential to the right is direct ownership of the property.

Secondly, depreciation need not arise from the use or employment of the property in the trade or business.[52] It is enough if the property is used in the trade or business.[53]

Thirdly, no depreciation will be allowed unless the asset has a limited and determinable existence. Although exhaustion may possibly be actually taking place, it must be susceptible of measurement.[54] It is, largely, for this reason that goodwill ordinarily is not considered a depreciable asset.

The rules and regulations regarding the above-mentioned conditions were adopted from the United States.

Depreciation is in every instance a question of fact and a matter of judgement. Whatever plan or method of apportionment is adopted must be reasonable.

Unlike France and Canada, in the Philippines any plan of computing depreciation in accordance with any recognized trade or practice, provided it is reasonable and has due regard to operating conditions during the taxable year, is acceptable.[55]

Where the useful life of the property will be longer or shorter than the useful life as originally estimated

under all the then known facts, the portion of the cost or other basis of the property not already provided for through depreciation allowance should be spread over the remaining useful life of the property, as re-estimated in the light of subsequent facts.[56]

The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would be allowable.[57]

The depreciation of an asset beyond its acquisition cost is not allowed. In Basilan Estates, Inc. v. Commissioner of Internal Revenue,[58] the taxpayer reappraised its assets by increasing it to conform it with the increase in cost for their replacement. It then computed depreciation based on the appraised value. The excess of the depreciation based on the reappraised value over the depreciation based on original cost was disallowed by the Commissioner. The Court declared that the Income Tax Law does not authorize the depreciation of an asset beyond its acquisition cost.

In Commissioner v. Priscila Estate, Inc.,[59] the taxpayer was engaged in the business of leasing real estate. Among its assets was the Priscilla Building No. 3. The Building had an assessed value of a little over ₱70,000. However, its construction cost exceeded ₱110,000. The

taxpayer acquired the building at its assessed value from its principal stockholders, in exchange for shares of stock. Later, the taxpayer revalued the property on the basis of construction cost. The question was whether to use the assessed value, which was the acquisition cost, or the construction cost as the basis of depreciation. It was held that the corporate investment would ultimately be the construction cost and that the depreciation should be computed on the said basis.

Mariano Zamora v. Collector of Internal Revenue[60] explains the factors that are considered in determining the depreciation rate for buildings. In this case, the Commissioner using as a basis Bulletin "F" published by the Internal Revenue Service of the United States allowed the taxpayer a depreciation rate of 2 1/2% of the Bay View Hotel Building instead of the 3 1/2% claimed by the taxpayer. In deciding in favor of the Commissioner, using the 2 1/2% based on Bulletin "F", the Court of Tax Appeals stated: "It is true that Bulletin "F" has no binding force, but it has strong persuasive force considering that the same has been the result of scientific studies and observation for a long period in the U.S. after whose Income Tax Law ours is patterned. The factors taken into account in justifying the 2 1/2% rate of dep-

reciation are: the trend of Ermita district, where the Bay View Hotel is located, to become a commercial district; the fact that the hotel has no room for improvement; and, the changing modes of architecture, styles of furniture and decorative designs, all of which must meet the tastes of a fickle public. The Court also declared: "The possibility that foreign companies, such as the Pan American Airways, may put up modern hotels in Manila, in which even the Bay View Hotel would be merely a collector's item is a matter that apparently involves deduction for extraordinary obsolescence, not ordinary depreciation deduction."

It should be noted that, as an incentive, corporations and enterprises registered with the Board of Industries are allowed accelerated depreciation.[61] Thus, an entity can accelerate the depreciation period depending upon the life span of the particular equipment to be depreciated. If the estimated life of the equipment is more than ten years, then a corporation can accelerate the depreciation for any period to twice as fast as the normal rate of depreciation.[62] In this manner, a corporation can recover as much as possible and as early as possible the capital used in the purchase of equipments.

As in France, in the Philippines, there is also no "recapture" provision.

With respect to the amortization of intangible capital assets, there is no difference between the rules existing in the United States and those in the Philippines.

CANADA

In Canada, the view is that a deduction for depreciation is not necessarily dependent on wear and tear, nor, in the case of natural resources, is it tied to exhaustion of the asset. Hence, the allowance is not referred to in the Act as a depreciation allowance, but as a "capital cost allowance". In this regard, Canada is peculiar as compared to the other countries subjected to comparative analysis.

Section 11(1)(a), ITA, is the statutory authority for the capital cost allowance. It allows the deduction of (1) such part of the capital cost to the taxpayer of property, or (2) such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation.

It is the practice, where depreciable property is destroyed and not insured, to treat such property as still entitled to allowance because such allowances are granted by Section 11(1)(a) notwithstanding the prohibition against deducting capital losses.

Under Section 11(1)(a), ITA, the taxpayer has a right to an allowance of part of the capital cost of pro-

perty or of an amount in respect of his capital cost, that is allowed by regulation. The capital cost allowance is computed on what may be termed the "diminishing balance system" whereby "a fixed rate of allowance in respect of the capital cost of income-producing assets is applied to the undepreciated capital cost of the assets, so that the amount of the allowance diminishes each year as the rate is applied to a smaller and smaller undepreciated capital cost."[63] Another distinguishing characteristic of the system is that, instead of applying the capital cost rate to each asset, all the assets of the business are grouped into classes and fixed maximum rates are established for each class.

Regulation 1100(3) provides that if a taxation year is less than 12 months in duration, the capital cost allowance under Regulation 1100(1)(a), (d) and (h) "may not exceed the proportion of the maximum amount allowable that the number of days in the taxation year is of 365." In accordance with Regulations 1100 (3a) and 1100 (3b), where a taxpayer dies in the middle of a fiscal period or taxation year, a similar apportionment is made for the fiscal period or taxation year, as the case might require.

In Risebrough v. M.N.R.,[64] it was declared that the capital cost allowance cannot be based on the market value

at the time of acquisition. It is allocated on the basis of the cost of the property to the taxpayer. There is also the additional requirement that capital cost must be related to acquisition by purchase or transfer. Thus, the capital cost of a patent to an inventor was the amount spent to acquire the patent and did not include the expenses laid out by an inventor over a period of 20 years in formulating his invention.[65]

Section 12(2), ITA, was also applied in Niessen v. M.N.R.,[66] in relation to the capital cost allowance. Here, the capital cost allowance on a Cadillac automobile used by an employee in the performance of his duties and claimed as a deduction under Section 11(11) in computing his income from an office or employment, was reduced by one-half on the finding that an expensive car was used in order to claim for capital cost allowance.

Section 20, ITA, contains special rules for determining capital cost in special circumstances. Accordingly, where a taxpayer acquires property for some purpose other than gaining or producing income and then commences at a later time to use it for the purpose of gaining or producing income, he is deemed to have acquired it at the time and at the fair market value as of the date of the change of user.[67]

No single method of valuation exists which would inevitably lead to an accurate apportionment of the purchase price between land and building.[68] However, in a case,[69] it was held that the allocation sale price between land and building on the basis of a municipal assessment is reasonable.

In accordance with Section 20(6)(a), ITA, where property has, since it was acquired by a taxpayer, been regularly used in part for the purpose of gaining or producing income from it or from a business and in part for some other purpose, the taxpayer is deemed to have acquired it for the purpose of gaining or producing income. The proportion of the property that the use regularly made of the property for ganing or producing income is of the whole use regularly made of the property, and he is deemed to have acquired it at a capital cost equal to the same proportion of its full capital cost.

Moreover, under Section 20(6)(f)(i), ITA, where, after having acquired property that is regularly used for gaining or producing income and for other purposes, the taxpayer increases the amount of use regularly made of the property for the purpose of gaining or producing income, he is deemed to have acquired, at the time of the increase, depreciable property of that class equal to the

proportion of the fair market value of the property at the time of the increase that the amount of the increase for business use is of the whole use regularly made of the property.

If a taxpayer received or is entitled to receive assistance from a government, municipality or other public authority in respect of or for the acquisition of property, the capital cost of the property is deemed to be reduced by the amount of the assistance.[70]

Pursuant to Section 20(6)(c), ITA, in case the property is acquired by gift, bequest or inheritance, the taxpayer is deemed to have acquired it at a capital cost equal to its fair market value at that time.

If an amount can reasonably be regarded as being in part the consideration for disposition of depreciable property of a taxpayer of a prescribed class and as being in part consideration for something else, the part of the amount that can reasonably be regarded as being the consideration for such disposition shall be deemed to be the proceeds of disposition of depreciable property of that class irrespective of the form or legal effect of the contract or agreement.[71] The person to whom the depreciable property was disposed of shall be deemed to have acquired the property at a capital cost to him equal to

the same part of that amount.[72]

If all the assets of a business are sold for unit consideration, the consideration must be apportioned between what pertains to depreciable assets, on one hand, and to non-depreciable assets, on the other. In the absence of contractual agreement on the consideration allocable to depreciable and non-depreciable property, an allocation to depreciable property of its fair market value in preference to its value in the eyes of either party will be considered as reasonable.

Where depreciable property owned by one person has by one or more transactions not at arm's length become vested in a taxpayer the capital cost to the taxpayer is deemed to be the capital cost to the original owner.[73]

In Ottawa Valley Power v. M.N.R.,[74] it was declared that it is doubtful whether Section 26(6)(c) applies to capital equipment supplied free of charge by one businessman to another for purely business reasons.

Rates of capital cost allowance are assigned to 18 separate classes of property by Regulation 1100(1)(a).

The rate established for each class is to be applied to the undepreciated capital cost of the assets in that class as a whole and not to individual assets within the class.[75] Furthermore, the rates are maximum rates -- the

taxpayer need not take the full amount allowed for depreciation in any given taxation year.[76]

Accelerated allowances are allowed for newly acquired plants and machinery, new buildings in depressed areas, and for new machinery in depressed areas.[77]

As in the United States, in Canada, Section 20, ITA, contains provision outlining a plan for recapture of excess depreciation allowed to taxpayers.

Under the provisions of Section 20, a taxpayer is required to bring back into income for tax purposes any depreciation claimed in previous years that was not in fact incurred. The recaptured income is determined from the sale price obtained on final disposal of the asset by the taxpayer. Recapture applies only to depreciation already taken or deemed to have been taken.

Since, under this depreciation system all assets are grouped into classes, and a rate is applied to the whole class rather than to individual assets in each class, depreciation is taken on, and proceeds of dispositions are deducted from the undepreciated capital cost of the properties of the class taken as a whole.[78] Thus, where there are a number of assets of a prescribed class, the recapture provisions result in the recapture of excess depreciation and its consequent addition to income only

when the total of the amounts received on the disposition of assets of a class exceeds the undepreciated capital cost of all assets of the group immediately before the disposition.[79] It should be underscored that the recapture provisions apply to the fiscal period of the taxpayer's business and to computation of the taxpayer's income from the business.[80]

Section 43, ITA, provides a measure of relief from the operation of Section 20 in recapturing a large amount of depreciation in one year to be taxed at graduated rates. It allows this added income to be spread over the five preceeding years.

It should be noted also that, pursuant to Section 20(8), ITA, the "recapture provision" does not apply in determining a taxpayer's income for a taxation year from farming or fishing unless he has elected to take a deduction for that or a previous year under regulations pertaining to "capital cost of property" made in accordance with the provisions of Section 11(1)(a) other than a regulation providing solely for an allowance for computing income from farming or fishing.

Patents, franchies, concessions, or licences for a limited period in respect of property is described as a special class of depreciable property in class 14 of

schedule B of the Regulations.

In accordance with Regulation 1100(1)(c), the amount that may be deducted each year in respect of the capital cost of such patents, franchises, concessions or licences for a limited period, may not exceed the amount for the year obtained by apportioning the capital cost of the property to the taxpayer equally over the life of the property remaining at the time the cost was incurred. The provision allows deductions according to the straight line principle of taking depreciation. This allowance does not extend to a franchise, concession or licence in respect of minerals, petroleum, natural gas, other related hydrocarbons or timber and property relating thereto, except a franchise for distributing gas to consumers, or in respect of a right to explore for, drill for, take or remove any of these products.[81] Neither does it extend to leasehold interests or to property coming within class 23 allowing a 100 per cent write-off for leased or concessioned property connected with the 1967 World Exhibition at Montreal.

Regulation 1100(9) provides a formula for computing the capital cost allowance for patents that are acquired wholly or partly in return for royalty payments based on their use.

Presently, there is a proposal pending before the

Canadian parliament which would sweep up all "nothings".[82] Thus, there will be a new depreciation class. This class of assets will be deductible at 10% of its book value per annum.[83] However, since "goodwill" is included in this new depreciation class, there will be special rules for it to avoid possible difficulties in computation.[84]

V. NET LOSS FROM OPERATIONS

FRANCE

In France, a loss in one category may be used to offset gains not only in the same category but also in other categories in the same year.[1] In addition, net losses are permitted to be carried forward against income over a five year period.[2]

Let us discuss the two points one by one.

In connection with offsetting in the same category, losses could be used to offset gains and vice versa. The matter is illustrated as follows: "An individual operating a bakery in one commune and a paint store in another commune... could use the losses of one to offset the gains of the other, since both were in the category of business income. An individual proprietor could use a loss suffered in his own business to offset gains realized in another business by a member of his family whose income was reported on his return under the system of taxing family income to the head of the household.... An individual proprietor could use a loss suffered in his own business to offset gains realized in a partnership of which he was a member, and vice versa."[3]

There are no complications in connection with offsetting of losses in one category with gains in other

categories.

With respect to carrying forward of losses, the general rule is that "only a taxpayer who suffers a loss may use it to offset gains realised in the same or later years."[4]

The said rule is subject to several exceptions.

In case of individuals, under the system of taxing family income to the head of the household, a loss suffered by one member of the family may be used to offset gains realized by another.[5] Moreover, a member of a partner may reduce his owns gains by his shares of partnership losses.[6] However, in R.M. 431, J.Q. 13 May 1959, Deb. A.N. p. 482, it was ruled that after the death of an individual proprietor, the heirs operating the business may not carry forward losses suffered by the decedent against their own gains in the same enterprise because different taxpayers are involved.

In case of corporations, the legal implications are explained thiswise: "If a profit corporation takes over a loss corporation by merger..., the surviving corporation (the profit corporation) is a different taxpayer from the corporation that suffered the loss. The surviving corporation may not use the loss of the merged corporation to offset its own gains. If a profit corporation and a loss corporation merge to form a new corporation, again, the

new corporation is not the taxpayer that suffered the loss; it may not use the loss of the predecessor corporation to offset its own gains. In theory, the situation is different if a loss corporation takes over a profit corporation and becomes the survivor. The surviving corporation is then the same taxpayer as the taxpayer that suffered the loss, and it may carry forward this loss to offset subsequent gains of the firm, even if these gains are derived from the operations of the formerly separate profit firm."[7]

The fundamental requirement, whether it be in the offsetting of losses with gains in the same or other categories, or the carrying forward of losses, is that the oldest losses should be used first.[8]

UNITED STATES

In the United States, under Section 172, IRC, no adjustment is made in computing the net operating loss for the excess of percentage over cost depletion, for tax exempt interest, or for the intercorporate dividends received deduction.[9] Morevoer, while the excess of non-business deductions over non-business income is still not allowed in computing net income, loss from the sale of real or depreciable property used in the trade or business is no longer treated as a non-business deduction.[10] The net operating loss computation under present law is, thus,

approximately equivalent to the computation of loss as shown on the income tax return.[11]

In brief, Section 172(c), IRC, provides that the term "net operating loss" means the excess of allowable deductions over gross income, subject to the modifications as follows:[12] 1) No net operating loss deduction is allowed in the case of non-corporate taxpayers. 2) Captial losses may not exceed capital gain, and long-term capital gains deduction is not allowed. 3) No deduction is permitted for personal allowances. 4) In the case of non-corporate taxpayers, non-business deductions are allowed only to the extent of non-business income (including the excess of non-business capital gains over non-business capital losses,) but losses from the sale of real or depreciable property used in the trade of business are considered business deductions, as are casualty losses with respect to non-business property. Any excess non-business income will offset business deductions, however. 5) Corporate taxpayers are not permitted the deduction allowed by Section 922, IRC.

The statute applicable to the year in which the initial loss arose is the law that determines the amount of the initial loss, so that this amount remains constant even though the law of the year to which it is carried would have produced a different result.[13] But the year to which

such initial loss is carried determines the adjustments to be made in the net income for that year.[14]

Under Section 172, IRC, a net operating loss sustained during the taxable year is carried back to the three preceding taxable years and carried forward to the five succeeding taxable years. The loss is first carried to the earliest of the three preceding years, then to the next earliest year, and so on, until exhausted. In determining the taxable income of any preceding year, certain special adjustments are required. Thus, the taxable income of any preceding year is computed without regard to the net operating loss for the loss year itself or for any year thereafter. Further, with respect to individual (or other noncorporate) taxpayers, the 50% deduction for long-term capital gains must be added back to taxable income. No offset against ordinary income is permitted for excess capital losses and no deduction is permitted for personal allowances.[15] As to corporations, the deduction otherwise provide by Section 922, IRC, (relating to Western Hemisphere Trade Corporations) is not allowed.[16]

The "net operating loss deduction" for any taxable year is the sum of aggregate of the net operating losses sustained in preceding and succeeding taxable years which may be carried back or carried forward to the taxable

year in question.[17] When losses are sustained in more than one preceding or succeeding taxable year, the losses of the earliest of these years is first taken into account.[18]

PHILIPPINES

In the Philippines, ordinary losses are deductible in computing income.

As already discussed, individuals can carry over capital losses and deduct it from capital gains in the next taxable year.

In a sense, unlike the United States and France, the concept of "net operating loss" is applicable in the Philippines only to the extent that certain losses, specified under Section 30(d), NIRC, as previously discussed, can be deducted from gross income of the taxable year when the losses are incurred. Taxpayers, as a general rule, are not allowed to carry back and/or carry forward their losses as in France, U.S., and Canada.

There is, however, an exception.

The exception relates to the grant of a loss carry over privilege as an incentive to enterprises registered with the Board of Investments.[19] Losses may be incurred by the registered enterprirse after its registration with the Board of Investments and losses incurred within the first ten years of the operation of the corporation may

be carried forward. Let us assume that a corporation was organized and began operating about nine years ago. At the end of the 9th year, it became a registered enterprise under the Board of Investments. Can it carry over the prior losses of the corporation during the 9-year period? No. In this case, it can carry over only the losses that may be incurred during the 10th year of its operation when it is both a registered enterprise and within the first ten years of the operation of the enterprise. If an enterprise has been operating for let us say 12 years and at the 12th year it became a registered enterprise under the Board of Investment, the provision is of no use to the enterprise. In computing net operating losses, the gross income of the corporation, whether taxable or not, must be included.

CANADA

In Canada, only the loss from carrying on business may be deducted. Moreover, in accordance with Section 27(1)(e)(iii), ITA, the loss is deductible only to the extent of the lesser of (i) the taxpayer's income for the taxation year from the business in which the loss was sustained and his income for the taxation year from any other business, or (ii) the taxpayer's income for the taxation year minus all the deductions permitted in computing taxable income ex-

cept the status and dependent deductions and, of course, the business loss deduction itself.

The distinction between a business and non-business source of income is obviously of importance.

"Loss" means a loss computed by applying, so far as they may be applied, the provisions of the Act regulating the computation of business income in accordance with Section 139(1)(x), ITA. But, where inter-corporate dividends are "included" in computing the business income of a corporation, they are excluded from their computation to the extent that they would be deductible in computing the corporate taxpayer's taxable income. The amount of business loss so computed is reduced by any amount by which that loss operated to reduce the taxpayer's income from other sources in computing the taxpayer's income from all sources for a taxation year.[20]

Section 27(1)(e), ITA, provides that, in computing taxable income for a taxation year, a taxpayer may deduct losses from business sustained in the five immediately preceding taxation years and immediately following taxation year.

In accordance with Sections 139(1)(x), 27(1)(e)(i), and 27(1)(e)(ii), ITA, the loss is mandatorily applicable first against income from other sources in the year of

loss, then against income for the preceding year, and then against income of succeeding years in their order of occurrence.

It should be noted that, under Section 27(5), ITA, previous business losses may not be written ahead in reduction of the taxable income of later years if the following conditions exist: (1) the business in which the loss is sustained is not carried on during the year in which the deduction is claimed; (2) between the loss year and the end of the year in which the deduction is claimed (i) over 50 per cent of the issued stock of the corporation was acquired before June 14, 1963, by persons who were not shareholders in the loss year, or (ii) control of the corporation was acquired after June 13, 1963, by persons who did not control the corporation in the loss year. Neither discontinuance of the business nor shift in control is in itself sufficient to preclude this deduction. "Control" of a corporation, in relation to the question of associated corporations, has been held to mean the power to vote more than one-half of its voting shares and the same view will likely prevail in this instance.[21]

Under Section 851(2)(i), ITA, where business corporations are amalgamated, business losses sustained by the previously existing corporations are not deductible in

computing the taxable income of the new corporations.

VI. ANALYSIS AND CONCLUSION

In order to thoroughly discuss the tax treatment of business income, it was necessary to approach the problem by way of comparative analysis of business income taxation in countries with tax systems, more or less, representative of those in existence in our global community.

As discussed earlier, France represented the civil law countries. The United States was chosen to represent countries under what may be termed as the common law codified tax system. The Philippines typified the set up in civil law countries utilizing common law tax concepts. Canada represented the systems under a purely common law scheme but influenced by American tax concepts.

In choosing France, Canada, U.S., and the Philippines, the fact that the Philippines and Canada are developing countries, on the one hand, and that the United States and France have attained the industrialized stage of economic development, on the other, was also considered as important.

Presently, there is nothing in the tax concepts obtaining in the countries being analyzed showing any significant relationship between the tax treatment of business income and the stage of economic development of a country.

Thus, the tax treatment of business income in the Philippines, a developing country, is similar to that of the United States, an industrialized nation. Moreover, the tax treatments of business income in Canada and the Philippines, both developing countries, are in numerous ways very different. Furthermore, although France and the United States are both industrialized nations, their methods and concepts regarding the taxation of business income are far from identical.

As previously stated, whether it be in France, U.S., Canada, or the Philippines, the taxpayers earning business income are the following: a) indiviudals conducting single proprietorship businesses; b) corporations; and, c) unincorporated business entities.

In all the countries under analysis, a single proprietorship is not considered as an entity separate and distinct from the individual owner for income tax purposes.

The income tax liability of the individual business owner in Canada and France depends upon whether he is a "resident" or a "non-resident". In the United States and the Philippines, the criterion is citizenship. The question of residence is only considered in case of aliens.

For purposes of tax administration, France and Canada should consider the possibility of utilizing citizenship

as the main criterion for fixing the income tax liability of individuals. It cannot be denied that it is relatively easier to determine whether or not a person is a citizen of a particular country as compared to whether or not he is a resident thereof. The reason can be traced to the fact that there are more factors that go into the determination of residence. The Philippine and American experiences have shown this. Revenue official encounter more problems fixing the tax liability of aliens because the criterion used for them is residence. On the other hand, there is almost no controversy involving the question whether a person is a citizen or an alien for income tax purposes. The amount of administrative difficulties that could be avoided by utilizing citizenship as the main criterion for fixing tax liability can be gauged from the fact the most of the individual taxpayers in any one country are citizens of the same.

The administrative difficulties confronting the Philippines and the United States with respect to the taxation of citizens residing abroad should not be used to support the assertion that residence is better than citizenship as a criterion. This will be discussed extensively later. At the moment, suffice it to say that, despite administrative difficulties, the little revenue raised from non-resident

citizens as a result of the application of the citizenship criterion is better than no revenue at all because of the utilization of the residence criterion. Moreover, the administrative problems encountered are not really that much because the number of citizens residing abroad is very limited.

Despite the difference in the criterion utilized among the countries under consideration, the uniform rule is that a "resident", whether citizen or alien, is subject to tax on income from all sources.

The income tax liability of a "non-resident" in France and Canada, whether he be a citizen or an alien ,is limited to the income earned in France and Canada, respectively. In the Philippines and the United States, a "non-resident" citizen is liable for income from both local and foreign sources. The business income tax liability of a "non-resident" alien in the United States and the Philippines is the same as that in Canada and France. The "non-resident" alien is liable only for his business income earned within the country.

Despite the divergence in the criterion utilized, the source liabilities of individuals in the countries under comparative analysis are identical except with respect to the treatment of American and Filipino citizens residing

abroad. The taxation of "non-resident" citizens on their foreign and local source income is founded on the fundamental precept that citizens should contribute in financing the essential operations of the government in order that they may enjoy the blessings of justice, liberty, and democracy. The fact that the citizen is residing abroad is not a justification for exempting him from being taxed on his foreign source income because as long as he remains a citizen he is entitled to all the rights and privileges pertaining thereto. The matter of residing abroad is of a person's own choosing. If he feels that he should not be made to share in the burdens of governance with respect to his foreign source income, he is at liberty to relinquish his citizenship. A man who desires to enjoy any right or privilege must be willing to accept the concomitant responsibilities. It is submitted that Canada and France should consider the validity of the rationale behind the taxation of non-resident citizens on their foreign and local source income.

With respect to the tax rates imposed on the income of individuals, those in the United States are the most severe. In terms of severity, those in Canada and France are, more or less, equal. The Philippine tax rates are exceedingly low when compared to the other countries

under comparative analysis. The state of the Philippine economy is such that it would be easy to predict that there would be no increase in the rates for about a decade or two. Majority of the Filipinos simply cannot afford to pay at higher rates.

Even assuming that Canada has already hurdled the "take off" stage of economic development it is submitted that its level of individual income taxation is relatively harsh. The tax rates should be lowered to lessen the burden of the common man. The problem of reduced revenue which would result from the lowering of the rates could be solved by considering other revenue producing vehicles that would not affect the majority of those who have less in life. An example would be the imposition of a documentary stamp tax on all negotiable instruments issued and on all legal, commercial, and conveyancing documents notarized and/or registered with any government registering agency. The tax will not be felt by the paying public because the raising of the needed revenue is not made to depend on the amount which any one individual must pay but on the number of the negotiable instruments issued and the volume of the legal documents notarized and/or registered. Thus, even if the amount of the tax payable on a document is small, the needed revenue could still be raised because

the number of instruments issued and documents executed as a result of the demands arising from the normal economic activity of a country would, undoubtedly, be considerable. It is not difficult to imagine other revenue producing vehicles of a similar nature.

Although France imposes reasonable rates in connection with individual income taxation, considering the state of its economy, it is not free from condemnation. The fact that it starts to tax individual income at the level of 2,400 Francs and imposes a uniform rate for income from 72,000 Francs and above simply means that the tax burden for the poor is extremely heavier as compared to those who earn more. It should be noted that, roughly, the equivalent of 72,000 Francs is only $14,400. There is a need to change this apparent effort to favor the rich.

In France, corporations are classified into either French corporation or foreign corporations . The "seat of management" test is utilized to determine whether a corporation is French or foreign. In Canada, corporations are either resident (domestic) or non-resident (foreign). In determining whether a corporation is resident or non-resident, both the "seat of management" test and the "place of incorporation" test are utilized depending upon (a) whether or not a corporation is incorporated in Canada and (b) the

date of incorporation of the entity in Canada.

In the Philippines and the United States, the "place of incorporation" test is utilized in ascertaining whether a corporation is domestic or foreign.

The "place of incorporation" test is better than the "seat of management" test. It is simply because there are more factors to consider in order to arrive at a decision in accordance with the "seat of management" test. Under the "place of incorporation" test, there is no room for mistake. Once you know the situs of the law under which an entity was incorporated, you are already certain as to whether it is a domestic or a foreign corporation.

Of course, because of the present administrative machinery existing in France, a lot of problems may be encountered if it shifts from the "seat of management" test to the "place of incorporation" test. However, there is no harm for France to seriously study the advantages and disadvantages that would ensue from the adoption of the "place of incorporation" test.

In France, U.S., the Philippines, and Canada, domestic corporations are subject to tax on "income" derived from both foreign and local sources. However, with respect to "business income", French domestic corporations are subject only to tax on amounts earned within France.

In connection with the tax rates imposed on domestic corporations, France is the only country with a flat rate. In the United States, Philippines, and Canada, there are two rates -- one rate for income up to a certain level and another rate for income beyond the first level-- for the purpose of lessening the burden of small businessmen.

France should study the possiblity of adopting the "two-rate" system in order to encourage investments, and accord small businessmen a fighting chance to compete with giant corporations.

Undoubtedly, the "two-rate" system is not a perfect one. Firstly, corporations can keep its taxable income to an amount lower than the first level to which the lesser rate is applicable through a variety of devices, such as the payment of remuneration to proprietors and shareholders. Secondly, it is possible that the tax saved as a result of the application of the "two-rate" system might not be channeled back to increase the capital of the business. Indeed, it cannot be denied that the above objections carry much weight. However, it cannot also be disputed that the existence of healthy small businesses are essential to the well-being of any economy. Thus, it becomes a question of priority. Which is more important the economic progress and development of a country or the fact that some

corporations are keeping their taxable income below the first level? Which is more weighty the economic development and progress of a nation or the possibility that some businessmen would not be utilizing their tax savings for business purposes? Certainly, there can be no choice other than the progress and economic development of a country.

It should be noted that France is not limited to the adoption of the "two -rate" system if it wants to help its small businessmen. It could also provide financial assistance to small growing businesses through a capital formation tax credit devise or by means of accelerating the deductibility of certain outlays. The Philippines, Canada, and the United States should also consider the feasibility of incorporating a capital formation tax credit devise and other methods of financially helping small businesses into their tax systems.

Unlike France and Canada, in the U.S. and the Philippines, for purposes of fixing the tax liability of a domestic corporation, there is no necessity to determine whether or not the corporation is doing business within the United States and the Philippines, respectively.

As to foreign corporations, the same are subject to tax liability only on income derived from local sources whether in France, U.S., Philippines or Canada.

Under U.S. and Philippine taxing statutes, foreign corporations are classified into residents and non-residents. Resident foreign corporations are taxed at the same rates as domestic corporations. However, non-resident foreign corporations are taxed at a flat rate on their gross rather than net income.

In Canada, aside from the tax under Part I of the ITA additional taxes on income are imposed under Part III and IIIA of the Income Tax Act.

In France, there is no difference between French and foreign corporations with respect to tax rates.

The equal treatment accorded to foreign corporations regarding the taxation of business income earned in France is incomprehensible. It is natural for any country to favor its domestic corporation if the criterion is the protection and development of the economic interests of its people. Even if the desire is to attract foreign investments, this is not sufficient to justify a policy of equal treatment.

In the Philippines and the United States, it must be pointed out that there is also a need to change the law regarding the tax treatment of resident foreign corporations. Even assuming that it is correct to accord them a more favorable tax treatment as compared to non-resident

corporations, they should not enjoy the same benefits as those granted to domestic corporations.

As in France and Canada, in the United States and the Philippines, it is necessary to determine whether or not foreign corporations are "carrying on business" within the U.S. or the Philippines, respectively, to fix the extent of their jurisdictional reach over the said corporations. The reason for the similarity is that, in the United States and the Philippines, the criterion for fixing the liability of foreign corporations is "residence".

In France, Canada, U.S., and the Philippines, general partnerships are not considered as distinct taxpaying entities separate from the individual partners.

In France and the Philippines, limited partnerships are, as a general rule, treated as corporations for tax purposes. In the United States and Canada, there is no difference between a general partnership and a limited partnership with respect to the mode of taxation and the liability of the individual partners.

The absence of any difference regarding the tax treatment of limited and general partnerships in Canada and the United States is due, perhaps, to the failure to realize the true nature of limited partnerships. The liability of limited partners extend only to their contributions to the

partnership. In this sense, there is no difference between a limited partner and a shareholder of a corporation. Hence, limited partnerships should also be taxed as entities separate and distinct from the individual partners.

The Philippine treatment of a limited partnership is peculiar in the sense that it does not distinguish between general and limited partners in the imposition of the corporate rate. Thus, even if there is only one limited partner and there are one hundred general partners, since, under Philippine law, the partnership would still be considered as limited, its income would be taxed at corporate rates. However, in France, the effect is also the same because it gives general partners the option to be taxed at corporate rates. Hence, in France and the Philippines, prospective businessmen should not overlook the tax treatment of limited partnerships in the choosing of the form of business organization they would want to carry on their business.

In Canada, France, and the United States, joint ventures are not also considered as entities separate and distinct from the individual members. In the Philippines, a joint venture is taxed as a corporation.

Considering the nature of a joint venture, the same should not be taxed as a corporation in the Philippines.

In France and Canada, lesser forms of business orga-

nizations are not treated as taxpaying entities distinct from the individual members. In the United States and the Philippines, lesser forms of business organizations are taxed as corporations because said organizations, as a general rule, fall within the meaning of "association".

It is submitted that the Philippines and the United States should change their definition of a "corporation". In this regard, the better criterion is the extent of the liability of the members of the"association" and not the fact that a business organization falls within the meaning of "association".

There are specific rules for ascertaining "gross business income" in France and Canada. As discussed earlier, the reason for the same is because, under the French and Canadian tax systems, income is classified into several categories. However, as a general rule, a uniform rate is imposed on all types of income.

Considering that they levy a uniform tax rate on all types of income, France and Canada should study whether or not the utilization of a global system of taxation would be more beneficial to them for purposes of tax administration.

However, in France, the distinction between gross business income and income from other categories is only

meaningful with respect to individuals because corporations are conclusively presumed to be incorporated for business purposes. Hence, all types of corporate income are generally considered to be business income. The said conclusive presumption does not obtain in Canada for purposes of imposing the corporate income tax.

Since there is really no purpose for incorporating a business entity other than the acquisition of profits, it is suggested that Canada consider the adoption of the "conclusive presumption" existing in France. It should be noted that the existence of the "conclusive presumption" does not affect the distinction between ordinary gains and capital gains.

The French Tax Code classifies income into seven categories. On the other hand, the Canadian Income Tax Act divides income into three types. The reason for the difference in the number of income categories can be explained by the fact that capital gains are not subject to tax in Canada and because the other types of income in France are included either under business income, property income, or income from office and employment in Canada.

Without taking into account the taxation of capital gains, it is respectively submitted that the classification of income in Canada, as compared to France, is more prac-

tical for purposes of tax administration. The French classification separates income categories which can be grouped under only one class and treated by a uniform set of rules. The Canadian classification is simpler and more logical.

In the Philippines and the United States, the tax systems are global and unitary in character. Income is not divided into different categories for purposes of imposing the income tax and, as a general rule, there is a uniform tax rate for income regardless of its derivation or source. Hence, in determining what constitutes "business income" in the United States and the Philippines, it is necessary to consider the legal interpretations given to the phrase "carrying on trade or business" in relation to the tax liability of non-resident aliens and foreign corporations.

In the Philippines and the United States, there are two important requirement in order to constitute a person as "engaged in trade or business". They are the "continuity" and the "active pursuit of profits" requirements.

The "continuity" factor connotes more than a single transaction. It refers to the situation of progression and sustained activity. It conveys the idea of business being done, not from time to time, but all the time.

The "active pursuit of profits" test requires that the activities or operations be for the purpose of live-

lihood or profit. However, actual profits need not be realized. The "active pursuit of profits" test sets investments activities apart from acts constituting "carrying on business" for the former does not make one "engaged in trade or business".

It should be noted that, in the Philippines, a non-resident alien who stays in the Philippines for more than 180 days is considered to be "engaged in business" in the Philippines. There is no similar rule in France, Canada, and the United States.

In Canada, as previously discussed, "business income" means income arising from the exercise of a profession, calling, trade, manufacture of undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include income from an office or employment.

The concept of "adventure in the nature of trade", as applied in Canada, does not prevail in France, the United States, and the Philippines. Indeed, the concept of "adventure in the nature of trade" is what complicates the meaning of "business income" in Canada. However, Canada cannot be blamed in this regard, because it needs the "adventure concept to tax profits arising from transaction ordinarily taxable in other countries under comparative

analysis but would escape tax in Canada on the ground that they are capital gains.

France, U.S., and the Philippines should study the feasibility of incorporating the "adventure in the nature of trade" concept into their respective system. The adoption of the concept would definitely mean the collection of more taxes because a lot of gains would not be accorded the preferential treatment given capital gains.

In France, income from business is income arising from the carrying on of an industrial, commercial, or mining activity, or from activity as an artisan. The meaning of "business income" in France is almost similar to that in Canada. The only difference is that income arising from the exercise of the liberal professions in France is not considered as business income. Moreover, as already explained, income from an "adventure in the nature of trade" is also not treated as business income in France.

In France, government grants and subsidies extended to business enterprises are subject to income tax. In Canada, grants and subsidies are normally, not subject to tax as being in the nature of capital gains. In the United States and the Philippines, subsidies and grants are not subject to tax only if the same partake of the nature of capital contributions.

The taxation of subsidies and grants in France without regard to its nature is erroneous.

In the Philippines, Canada, France, and the United States, income arising from illegal business activity is subject to tax. There are those who claim that, if an activity is declared by the State as illegal, it is but logical and moral that it should not profit from the fruits of the illegality through the instrument of taxation. The claim is, of course, erroneous. The State should tax income arising from illegal activity because, by refusing to do so, it would be sanctioning dishonesty and placing honest businessmen at a distinct disadvantage.

However, in the United States and the Philippines, unlike Canada and France, in no instance is a receipt arising from a gift taxed as income. The reason for the non-taxation of income arising from gifts in the United States and the Philippines is the fact that the donor and the donee are already subject to transfer taxes on the same.

As previously mentioned, in Canada, capital gains are not subject to tax. However, in France, with respect to individuals, gains arising from the sale of non-business capital assets are not subject to tax. In the Philippines and the United States, this rule does not prevail. In the latter countries, gains arising from the sale of capital

assets, whether business or non-business, are subject to tax.

It is noteworthy to mention that, in the Philippines, unlike the United States, non-resident aliens are subject to capital gains tax. The United States should also tax non-resident aliens on their capital gains to be consistent with the policy that aliens, as compared to citizens, must not be granted any undue advantage in connection with income taxation.

In France, the manner of taxing capital gains is not systematic and very complicated. The reason is simply because France tried to integrate American tax concepts with the civil law system of treating capital gains. As explained earlier, the Philippine experience has shown that this can only result in confusion. There is no way by which common law concepts could happily be reconciled with civil law ideas. The only alternative available to France is either to adopt the American system all the way or simply to return to the purely French manner of treating capital gains.

In France and Canada, the problem of what constitutes capital gains is considered in relation to the meaning of "business income".

In France, income is considered to be from business,

as distinguished from capital gains, if it arose from "habitual trading". In ascertaining whether "trading" is habitual, the number of transactions, the length of the various holding periods, the number and nature of the properties involved, and the magnitude of the operations are taken into account. If on the basis of the factors enumerated, there is no "habitual trading", the profits arising from the transaction are considered as capital gains.

In Canada, there are several indicators to ascertain whether a profit is a capital gain or a business income as follows: 1) frequency of transactions; 2) the nature of isolated transactions; 3) adventure in the nature of trade; 4) related business activities; 5) subject-matter of the transaction; 6) organized efforts; 7) object of a corporation; 8) intention of the taxpayer; 9) fixed or circulating assets; and, 10) other miscellaneous factors.

A cursory examination of the above indicators will show that the manner of ascertaining what constitutes "capital gain" in Canada is similar to France. The only difference is that, in France, the indicators are utilized to determine the existence of habitual trading. Once it is established that the profit arose from habitual trading, the same are considered as business income rather than a

capital gain. In Canada, "habitual trading" is not the main key to the problem. In fact, even in the absence of habitual trading, if the transaction is an "adventure in the nature of trade", the profits arising therefrom will be considered as business income. Thus, all the indicators obtaining in a particular case are considered and, on the basis of the weight of the respective indicators showing that the profit is either a business income or a capital gain, a decision is made.

In the United States and the Philippines, the concept of business income is not taken into account in the determination of what constitutes a capital gain. In the said countries, if the transaction is a "sale or exchange" and if what is sold or exchanged falls within the scope of the term "capital assets", the income arising therefrom is considered as a capital gain.

The difference in approach as to what constitutes a capital gain between Canada and France, on the one hand, and the United States and the Philippines, on the other, can be explained by the fact that income in the latter countries is not categorized. However, there is no fundamental reason that would prevent France and Canada, if they so desire, from adopting the American approach regarding what constitutes capital gains. The fact that, under the

French and Canadian systems, income is categorized, would not be a bar because "capital gains" could be considered by itself independently of other concepts. It cannot be denied that the American approach is simpler to apply and implement.

Whether in the United States, Canada, Philippines, or France, there are specific income items which are excluded from gross income for tax purposes. The reasons vary. As a general rule, the exclusion is based on broad policy considerations directly or indirectly linked with the social, political, and economic life of the people. Thus, certain social and welfare payments are not included in computing income. At times, the reason is simply because the items in question are already subject to some other tax, such as the inheritance or gift tax.

With respect to income items excluded from gross income, there is no significant difference among the countries under comparative analysis.

There are certain receipts arising from business which are, ordinarily, treated in a different manner for tax purposes.

Thus, regarding accumulated profits, in the Philippines and the United States, an additional tax is imposed on the same. In France and Canada, there is no additional

tax on accumulated profits.

In Canada, corporations are given the privilege to be taxed at a much lower rate on dividends declared out of accumulated profits. This will not prevent the accumulation of profits. As long as businessmen are not prohibited from accumulating profits and it would be more beneficial for them to do so, they will continue to accumulate profits.

Canada and France should study the possibility of imposing an additional tax on accumulated profits.

The absence of an additional tax on profits accumulated is good for businessmen but bad for the government. Corporations can, thus, accumulate profits and use whatever should have gone to the government by way of taxes due from the shareholders to earn more profits.

As to the receipts of personal holding companies, in the United States and the Philippines, the receipts of certain domestic corporations falling under the definition of "personal holding companies" are subject to additional income tax. The main reason for the additional tax on personal holding companies is to prevent the practice of accumulating profits through holding companies and, thus, evade the taxation of income under higher rate levels for individuals. In France and Canada, there is no additional tax

imposed on the income of personal holding companies.

The French way of approaching the problem of corporate accumulations is, as already discussed, by granting corporations certain tax incentives if they, instead of accumulating the profits, declare the same as dividends.

It is clear, therefore, that, in Canada and France, the measures existing for the purpose of preventing tax postponement through corporate profit accumulations are not sufficient.

In France, Canada, and the United States, as earlier mentioned, there are certain benefits granted to domestic investment companies in connection with the taxation of its receipts.

Investment companies should be accorded preferential tax treatment because, through the said companies, small investors are able to make their hard-earned savings grow with very little risk and at a minimum outlay. By acquiring a participation in an investment firm, and, thus indirectly, in its securities portfolio, the small investors are investing with the benefit of the professional knowledge of investment experts without additional cost on their part.

The fact that there are persons utilizing investments companies simply to promote their own selfish interests

should not be used as an argument to minimize the importance of investment companies to a healthy economy and for removing the preferential tax treatment accorded them. The remedy is for the government to closely regulate the operations of investment companies. In the Philippines and the United States, if the investment company falls under the definition of a "personal holding company", the same is also subjected to the additional tax on accumulated profits which is more severe than the ordinary tax on accumulated profits. Perhaps, this is another reason why Canada and France should impose an additional tax on personal holding companies.

In The Philippines, there are no special tax benefits accorded to investment companies. Considering the importance of investment companies, it is suggested that the Philippines should legislate on the matter.

In Canada, France, Philippines, and the United States, banks enjoy certain benefits with respect to the non-inclusion of certain sums set aside as reserves in computing income. However, in France, banks, unlike ordinary French corporations, are not allowed to claii a "fictitious credit" on income withheld at source.

The preferential treatment accorded banks is justified. The maintenance of reserves by banks is necessary for the protection of the depositing public. It would be unfair to

include in the computation of income the sums set aside as reserves because the banks do not make use of the same profitably while they are allocated as such. Moreover, no economy can long endure without the existence of banks. Considering the importance of banks, it is strange that, in France, ordinary corporations are treated more favorably than banks with respect to the "fictitious credit".

In connection with domestic life insurance companies, in France, U.S., Philippines, and Canada, said companies are accorded benefits with respect to the non-inclusion of certain reserves in computing income. In France, Canada, and U.S., domestic life insurance companies are subject to the same income tax rates applicable to other corporations.

As a general rule, foreign life insurance corporations are treated, for tax purposes, like other ordinary foreign corporations in all the countries under comparative analysis.

With respect to the different treatment accorded foreign life insurance companies, as compared to domestic life insurance companies, the reasons cited in the discussion relating to domestic and foreign companies are applicable.

As to non-life insurance corporations, in general, the rules with respect to ordinary corporations apply to them

in the United States, Canada, and the Philippines. This is the better rule. In France, non-life insurance companies are treated in the same manner as life insurance companies. The French rule should be changed. There is sufficient justification to distinguish between life and non-life insurance companies. The tax benefits granted to domestic life insurance companies can be justified by the fact that the reserves they maintain are required so that they would always be in a financial position to comply with their commitments to the insuring public. The proceeds of life insurance policies are, usually, badly needed by those who are left behind by the assured, in most instance the breadwinner of the family, during the critical period immediately after his death. Hence, since the reserves of life insurance companies, as compared to non-life insurance companies, are being maintained for this very important social purpose, it is simply fair that the sums set aside for their reserves be not included in computing income More-over, unlike life insurance companies, most non-life insurance companies reinsure the risks covered by their policies with bigger companies in order to minimize their loss in case of unforseen calamities. Consequently, non-life insurance compnies are in a better

position to comply with their commitments to the insuring public.

Unlike France, Canada, and the United States, in the Philippines, domestic mutual non-life insurance companies are treated like domestic life insurance deductions. This equal treatment is based on the nature of "mutual entities" which will be discussed later.

It should be noted that, in the United States, a tax exemption is granted to small mutual insurance companies with gross receipts not exceeding $150,000. There is no similar exemption in the Philippines and Canada. In France, the mutual company is exempt from tax on income arising from its principal activity (insurance) and subject to the lower tax rate of 24% on its income from real property, farms and forests, and movable capital. Mutual insurance companies are organized primarily for the purpose of simply benefiting its members or protecting them from specific risks. Thus, mutual companies, normally, are prohibited from issuing life insurance policies, their managers or administrators do not receive any compensation, and are required to divide among their members the excess of receipts over expenses and required reserves. It is suggested that the Philippines and Canada consider the

possibility of adopting either the American or French system of taxing mutual insurance companies.

In France, U.S., Philippines, and Canada, subject to the fulfillment of certain requirements, the income of private educational institutions are not taxable. In the Philippines, even if the requirements for exemption are not fulfilled, the income of the institution is subject to a flat tax rate of only 10%. There is no similar provision, regarding the matter in France, Canada, and the United States.

In accordance with the precept that a country can only find fulfillment in the task of nation-building with an enlightened citizenry, it is recommended that the favorable treatment accorded private educational institutions in the Philippines be adopted by Canada, France, and the United States.

The tax systems of France, U.S., Canada, and the Philippines are basically a tax on net income. The tax rates are imposed on gross income less the allowable deductions. There is no difference among the countries under analysis in this connection.

With respect to the allowable deductions from gross business income, in Canada, France, the United States, and the Philippines, residents and non-residents, regardless of whether they are citizens or aliens, are entitled to

deduct expenditures related to the production of local income. Thus, despite the difference in the criterion utilized for fixing the tax liability of an individual between Canada and France, on one hand, and the United States and the Philippines, on the other, the ultimate legal effect is the same.

As to corporations, in France, only domestic or French corporations are entitled to deductions. Foreign corporations, subject to certain exceptions involving royalties, are not entitled to any deduction. In Canada, both resident and non-resident corporations are entitled to deduct expense items connected with the production of income from local sources. In the United States and the Philippines, domestic and resident foreign corporations are entitled to deduct expenditure related to income arising from domestic sources. Only non-resident foreign corporations are not entitled to any deduction in the said countries.

Although one should distinguish between domestic and foreign corporations for tax purposes, unless there is any other fundamental reason in law, it is submitted that foreign corporations doing business within a particular country should be allowed to deduct expenditures connected with the earning of domestic income. In this regard, the French treatment of foreign corporations appears

to be ill-considered. Nationalism is laudable. But if its effect is to create an atmosphere of oppression and thereby drive away badly needed foreign investments, its perpetuation becomes prejudicial to the greater interests of a nation.

As explained earlier, basically, there are two types of deductible expense items: the so-called personal deductions and the income-connected deductions. Personal deductions are mostly available to individuals under specific statutory authority. With respect to the tax treatment of business income, there is nothing different that is of particular significance among the countries under analysis pertaining to personal deduction.

Regarding the concepts and limitations involving income-connected deductions, although the numerous tests in order to qualify an expense item for deduction, are referred to by various terms in the countries under analysis, the said terms are actually identical whether in France, Canada, the Philippines, and the United States.

In Canada, the first requirement is referred to as the "ordinary principles of commercial trading or accepted business practice" test. In the United States and the Philippines, it is called the "ordinary and necessary" requirement. In France, it is the "interest of the firm

and in connection with the operation" test.

With respect to the second requirement, in Canada, it is called the "for the purpose of gaining or producing income" test. In the United States and the Philippines, the counterpart is the "for carrying out any trade or business" requirement. In France, it is the "for acquiring and protecting income" test.

As to the third requirement, whether in France, the United States, Canada, or the Philippines, the rule is simply that capital expenditures, as distinguished from ordinary business expenses, are not deductible.

It should be noted that, in Canada, there is still a controversy as to whether the second and third requirements are two separate and independent tests or simply parts of the so-called "income-earning process" test. It is suggested that the Supreme Court should immediately resolve the question in order to minimize confusion.

With respect to the test of "reasonableness" in Canada, the equivalent in France is the doctrine of the normality of payments. Unlike France and Canada, in the United States and the Philippines, the principle of "reasonableness" is specifically applicable only to expenses arising from compensation for services rendered.

There is no justifiable reason why the requirement of

"reasonableness" in the Philippines and the United States should be limited only to expenses arising from compensation for services rendered. The Philippines and United States should adopt the rule prevailing in France and Canada.

In France, the United States, Philippines and Canada, the expenses claimed as deductions must, as a general rule, be substantiated. There can be no dispute regarding this requirement.

In the United States and the Philippines, there is also the so-called "public policy" requirement. In general, the rule states that, if the deduction of an expense would be contrary to a declared public policy of the State, the same would not be allowed. In France, although the concept of "public policy" is not specifically mentioned, the tendency is to disallow the deduction of expenses incurred in connection with an illegal activity. However, in Canada, the rule is different. The prevailing doctrine is that, since income from an illegal activity is taxable, the expenses arising therefrom should also be deductible.

Canada should reconsider its present rule that allows the deduction of expenses arising from an illegal activity. It should favor the honest businessman and penalize the dishonest by not allowing the deductions of disbursements

arising from an illegal activity on grounds of public policy.

In connection with specific deductible or non-deductible items there are certain business expenses involving the existence and operation of an enterprise. For purposes of this thesis, the said expenses were designated as "initial and operational expenses". The expenses discussed under this classification were: i) organization expenses; ii) compensation for services rendered; iii) rentals; iv) expenses for repairs and maintenance; v) insurance premium payments; vi) travel and entertainment expenses; vii) expenses for business gifts; viii) payment of fees; and, ix) expenses to restrict competition.

As to organizational expenses, in France, the business firm may opt to deduct them in full in the year they were incurred or write them off over a number of years. In the United States, Canada, and the Philippines, there can be no full deduction of the expenses in the year the same were incurred but a write-off of the same over a number of years is allowed.

The French rule regarding organizational expenses is better. The most critical years for businessmen are those during the initial years of operation. In order to create a favorable climate for investment and to assist small businessmen, the better policy is to give small enter-

preneurs less problems during the early stages of their operations. In the long run, this policy would bring more revenue to the government because, if the businessmen are successful in their ventures, they would be earning more profits. The direct consequence, of course, is more taxes for the government to collect.

In France and Canada, expense to restrict competition are, subject to certain exceptions, allowed as deductions. In the Philippines and the United States, the said expenses are considered as capital outlays and are not allowed as deductions. It is submitted that the better rule is the one obtaining in Canada and France. The nature of the expense to restrict competition should be analysed. If the expense is for the purpose of acquiring a business, it is definitely an acquisition of a capital asset. Hence, the deduction of the expense should not be allowed. However, if the expense is simply for the purpose of adopting a scheme to increase the chances of the taxpayer to earn more income or to survive competition, the deduction of the expense in question should be allowed.

Regarding compensation for services rendered, unlike the United States, the Philippines, and Canada, in France, additional tax penalties are imposed upon corporations for failure to disclose the identity of recipients of the

compensations paid and claimed as deduction. The imposition of the additional tax penalties in France appears to be too severe. The disallowance of the deduction is already sufficient punishment for the failure to disclose the identity of the recipient. Indeed, the compensation paid should not be allowed as a deduction because of thefailure of the taxpayer to substantiate his claim. The fact that the unknown recipient might excape income taxation has nothing to do with the problem of deductions. Besides, the amount of compensation of the unknown recipient can be traced by means of the net-worth method of assessment and other tax evasion safeguards.

In France, the Philippines, and the United States, disbursements for premiums on insurance taken on the life of employees are, except when the proceeds are payable to the employer, deductible from gross income. In Canada, expenses for insurance premiums are deductible only when the insurance is in the nature of a retirement savings plan. It is submitted that the Canadian rule should be changed. In accordance with the general principles on deductibility, the premium payments are clearly deductible.

With respect to the other items falling under the classification "initial and operating expenses", the same are generally considered as deductible whether in France,

Canada, Philippines, or the United States.

As to the deductibility and the treatment of expenses pertaining to retirement and other employee benefits, subject to minor differences, the applicable rules are similar in France, U.S., Philippines, and Canada. The said items are all deductible from business income.

With respect to the deductibility of bad debts, unlike France and Canada, in the United States and the Philippines, non-business bad debts are deductible from business income. The reason for the difference can again be traced to the fact that, in the Philippines and the United States, income is not categorized.

In the United States and the Philippines, to be deductible, there is no requirement that the interest paid should arise from an indebtedness related to the taxpayer's trade or business. In France and Canada, the indebtedness must be related to the business or trade of the taxpayer. The reason for the difference is the same as that with respect to the deductibility of bad debts.

In connection with the deductibility of bad debts and interest payments, the rule in the United States and the Philippines is more realistic and reasonable. Considering the truism that without, any financing or capital, no man could engage in business, the lending and borrowing activi-

ties of the taxpayer should not be dissociated with his business activity. Indeed, the lending and borrowing activities of any person affects his total financial position and, most likely, also, the conduct of his business. The correctness of this view is more emphasized when we consider the travails of the small businessmen. By allowing them to deduct non-business bad debts and interest payments arising from transactions not related to their business, the State would be maximizing theirchances of vaulting over the "break-even" stage of their business operations. It cannot be disputed that this would redound to the benefit of the economy and the nation. Of course, it need not be said that the State would also be collecting more taxes because of the resulting prosperity.

In connection with dividend distributions, in France, Canada, Philippines, and the United States, corporations are not allowed to deduct it in computing income. However, in France, dividends paid on new shares, issued at the organization of a new corporation or on an increase of capital of an existing corporation, if the sums paid in for the share are used in connection with plans for modernization, are deductible. The deduction allowed in France with respect to dividends paid on new shares is a good way of attracting investments and achieving modernization in

In France, except for dividends received by parent holding companies from subsidiaries as previously discussed, there is no tax exemption for dividends received by a corporation from other corporations. In the United States and the Philippines, the exemption is limited to 85% and 75%, respectively, of the amount of the dividends received. In Canada, the exemption is for the full amount of the dividends received.

France, the United States, and the Philippines should follow the Canadian example regarding the full exemption from income taxation of amounts received as dividends by a corporation from another corporation. Triple taxation of the same income is simply too much.

As a general rule, in the United States, Canada, Philippines, and France, charitable contributions are deductible only up to the extent of a certain amount. However, in the Philippines charitable donations to certain agencies are, in accordance with special laws, deductible in full. Moreover, in France, charitable contributions directly benefiting a business firm or its employees are fully deductible. It is submitted that, with respect to the deductibility of charitable contributions, the French rule allowing the deduction in full if the contribution directly benefits the firm or its employees is the best.

If contributions of the employer to pension or retirement plans are deductible in Canada, the United States, and the Philippines, there is no reason why charitable contributions directly benefiting the employees of the donor should not be deductible in full. Likewise, there is no denying that charitable contributions are usually made because of business reasons rather than sheer benevolence. Why then should the full deduction of a charitable contribution be denied if it was incurred for thepurpose of earning income and directy benefits the donor?

In the United States and Canada, subject to certain conditions, research and experimental expenditures are deductible in full. In France, if the same is an ordinary business expense, there is also no limit to the amount deductible. In the Philippines, there are no provisions in the NIRC pertaining to research and experimental expenditures of business enterprises. Nevertheless, the same could be deducted in full if it qualifies as an ordinary business expense. It should be noted that in Canada and the United States, research and experimental expenditures can be treated either as current expenses or be capitalized. This rule should be adopted in France and the Philippines in order to lessen the burden of businessmen during difficult times.

In connection with ordinary losses, the same are, subject to certain requirements deductible in Canada, France, Unites States, and the Philippines. Capital losses are not deductible in Canada. In the Philippines, U.S., and France, capital losses are, ordinarily, deductible from capital gains. In the United States, capital losses are, to a limited degree, deductible from ordinary gains. The rule prevailing in the United States is a good one. Truly, a loss, whether ordinary or of a capital nature, is a loss which affects the financial stability of the taxpayer.

In France, U.S., Canada, and the Philippines, deductions are allowed for depletion. However, there are certain differences in the manner of calculating the depletion allowance. In the United States and France, the allowances could either be a cost depletion allowance or a percentage depletion allowance. In the Philippines, the allowance is only a percentage depletion allowance and, in Canada, the allowance is a cost depletion allowance.

The manner of calculating the depletion allowance in France and the United States is better than those in Canada and the Philippines. The reason is simply because, in France and the United States, the taxpayer is given two choices regarding the manner he wants his tax liability to be ascertained in connection with depletion. In this

manner, the taxpayer has less grounds to complain about the heavy burdens of taxation.

In connection with taxes, dominion (federal or national) income taxes paid by business enterprises in Canada, U.S., France, or the Philippines are not deductible from income. However, payments with respect to other forms of taxes are, as a general rule, deductible. In France and Canada, business enterprises are not entitled to credit on foreign taxes paid. Nevertheless, the same are deductible from business income. In the United States and the Philippines, the tax payments are either deductible or creditable at the option of the taxpayer. As explained before, a tax credit is more beneficial to the taxpayer when compared to a mere tax deduction. If the taxpayers of other countries are entitled to the benefits of a tax credit, there is no reason why Canadian and French taxpayers should be denied the same. It is suggested that Canada and France should incorporate the appropriate provision in this regard in their respective tax codes.

As to depreciation of capital assets, in the United States and the Philippines, any reasonable and consistently applied method of computing depreciation is sufficient. In France, in accordance with the CGI, the declining-balance system must be used for depreciating machinery and

equipment. With respect to buildings, subject to certain exceptions to encourage investments and the tourism industry, only the straight-line depreciation system may be used. In Canada, in accordance with the ITA, subject to some minor exceptions, only the capital cost allowance method may be used.

The Canadian method of depreciation is the most practical and realistic. Indeed, it is very difficult to estimate the decrease in value of a capital asset on the basis of use, exhaustion, or obsolescense. Thus, it is better to compute depreciation on the basis of its cost and the nature of the asset.

The "recapture provision" under Canadian and American taxing statutes should also be incorporated in the respective tax codes of France and the Philippines. The rationale behind it is correct. France and the Philippines have been losing a lot of revenue because of the absence of this "recapture provision".

Regarding the amortization of intangible capital assets, except as to the length of the period of amortization allowable, there is barely any difference with respect to the rules prevailing in France, U.S., Canada, and the Philippines.

Finally, with respect to the treatment of net loss

from operations, in the Philippines, in general, losses cannot be carried forward or backward. However, as an investment incentive, certain enterprises are allowed to carry forward losses incurred within the first ten years of operation of the enterprise claiming the deduction.

In the United States and Canada, business losses may be carried forward and backward. With respect to the question as to how far back or forward losses may be carried, the United States is more liberal than Canada. However, in the United States the carry forward and backward privilege is applicable only to corporate taxpayers. In Canada, it is applicable to both corporate and non-corporate taxpayers.

In France, losses can only be carried forward and the privilege is accorded to both corporate and non-corporate taxpayers.

The Philippines should amend the NIRC by allowing the taxpayers to, at least, carry forward their losses irrespective of whether or not an enterprise is registered with the Board of Investments to lessen the tax burden of Filipino businessmen. There is no fundamental reason why the Philippines should deny to Filipino enterpreneurs a privilege granted by other countries to their businessmen. By allowing businessmen to carry forward their losses, they

would be in a better position to finance their businesses and earn more profits. The end-result would be more taxes being paid to the government.

Viewed in the light of all the foregoing, it is clear that, subject to certain minor exceptions, there is no difference between the tax treatment of business income in the United States and the Philippines.

It cannot be denied that there are numerous differences with respect to the concepts utilized among the countries under comparative analysis in connection with the treatment of business income. However, despite the divergence in concepts, the ultimate tax consequences in almost all situations are nearly similar, if not identical.

In connection with the question as to which among the countries under comparative analysis has the best system of taxing business income, it should be noted that the methods of business income taxation in France, Canada, the Unites States, and the Philippines are all based on the principle of ability to pay, as distinguished from the benefits-received doctrine.

Economist Adam Smith in his "Wealth of Nations" mentioned three standards that must be observed in levying a tax in accordance with the "ability-to-pay" doctrine, as follows: 1) Certainty. "The tax which each individual

is to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person." 2) Convenience. "Every tax ought to be levied at the time or in the manner, in which it is most likely to be convenient for the contributor to pay it." 3) Efficiency or economy. "Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."

It is respectfully submitted that, although there are differences in the concepts and methods utilized, all the countries under comparative analysis, subject to the recommendations and suggestions herein made, can rightfully claim that their respective tax treatment of business income is in accordance with the standards laid down by Adam Smith.

FOOTNOTES

CHAPTER I

1. United States will, at times, be referred to as U.S. in this work.

2. The French Tax Code is called the Code General des Impots. In this thesis, CGI will, at times, be used to refer to it.

3. The American Tax Code is known as the Internal Revenue Code of 1954, as amended. Here, we will, most of the times, refer to it as IRC.

4. The Philippine Tax Code is known as the National Internal Revenue Code of 1939, as amended. In this work, NIRC will, at times, be used to refer to it.

5. The Canadian Income Tax Act will, at times, be referred to as ITA.

6. Perry, Taxation in Canada, 45 (3rd Ed. 1961)

7. Id.

CHAPTER II

1. Tax and Trade Guide: France, Arthur Anderson & Co., 8 (1961).

2. Id.

3. Taxation in France, World Tax Series, Harvard Law School International Tax Program, Commerce Clearing House, Inc., 712 (1966).

4. In case of French citizens, all his interests, not only his economic interests are considered. This can be gleaned from a reading of C.E. 11 March 1964, No. 55,305; C.E. 7 December 1960, No. 45,310; and, C.E. 23 April 1958, No. 37,792. See also Taxation in France, supra at 710.

5. Id.

6. Id.

7. Id.

8. C.E. 20 December 1937, No. 58, 316.

9. Taxation in the United States, World Tax Series, Harvard

Law School International Tax Program, Commerce Clearing House, Inc., 347 (1963).

10. Id.

11. 24 F. 2d 918 (1928)

12. 180 F. 2d 969 (1950).

13. 155 F. 2d 513 (1946), cert. denied, 329 U.S. 801 (1947), 67 S. Ct. 491, 91 L. Ed. 685.

14. White v. Hofferbert, 88 F. Supp. 457 (1950).

15. BTA Case No. 181, June 25, 1955.

16. LaBrie, The Principles of Canadian Income Taxation, 13 (1966).

17. 50 D.T.C. 437 (App. Bd).

18. [1949], Ex. C.R. 91, 49 D.T.C. 536

19. [1946], S.C.R. 209, 2 D.T.C. 812.

20. [1962] Ex. C.R. 328, 62 D.T.C. 1225.

21. Perry, Taxation in Canada, 46 (3rd Ed. 1961).

22. With respect to the Philippines and the United States, the term "resident citizen" is not accurately used because the terms "resident" and "non-resident" apply only to aliens.

23. Taxation in France, supra n. 3 at 708, 713.

24. Taxation in the United States, supra n. 9 at 351.

25. LaBrie, supra n. 16 at 16.

26. CGI, Article 164-1.

27. Taxation in the United States, supra n. 9 at 981.

28. NIRC, Section 21.

29. As to the United States and the Philippines, the term "non-resident citizen" is not accurately used because the terms "resident" and "non-resident" apply only to aliens.

30. Taxation in France, supra n. 3 at 755.

31. Id. at 756.

32. Taxation in the United States, supra n. 9 at 351.

33. Eighteenth Report of the Standing Committee on Finance, Trade, and Economic Affairs Respecting the White Paper on Tax Reform, House of Commons, Second Session, 28th Parliament, at 89 (1970).

34. Under the family-quotient system, the aggregate family income is divided into parts, the number of parts increasing roughly in proportion to the number of members in the family unit irrespective of whether or not the same members earn income. The total tax due from the head of the household is determined by computing the tax due on one part, and multiplying this amount by the total number of parts. See also CGI, Articles 193, 194.

35. Taxation in France, supra, n. 3 at 267.

36. Id.

37. 11 T.C. 127 (1948).

38. 185 F. 2d 584 (1950).

39. Adda v. Commissioner, 10 T.C. 273 (1948), aff'd, 171 F. 2d 457 (1948), cert. denied, 336 U.S. 952 (1949), 69 S. Ct. 883, 93 L. Ed. 107.

40. Von Bumback v. Sargent Land Co., 242 U.S. 503 (1917), 37 S. Ct. 201, 61 L. Ed. 460.

41. Pinchot v. Commissioner, 113 F. 2d 718 (1940).

42. McCoach v. Minchill & S.H.R.R., 288 U.S. 285 (1913), 33 S. Ct. 419, 57 L. Ed. 842.

43. Investors' Mortgage Security Co., P-H 1945 T.C. Memo Dec. par. 45,022, 4 T.C.M. 45 (1945).

44. Linen Thread Co. v. Commissioner, 14 T.C. 725 (1950).

45. 323 U.S. 119 (1944), 65 S. Ct. 169, 89 L. Ed. 113.

46. European Naval Stores Co., supra n. 37.

47. Amalgamated Dental Co., 6 T.C. 1009 (1946).

48. IRC, Sections 871 (a) (1) (2).

49. CTA Case No. 176, November 14, 1956.

50. G.R. No. 7924, September 30, 1955.

51. 48 O.G. 73.

52. BIR Ruling No. 324, July 13, 1959.

53. Ramirez v. Commissioner, CTA Case No. 544, September 15, 1957.

54. Tax and Trade Guide: France, supra n. 1 at 9.

55. Taxation in France, supra n. 3 at 714.

56. Id.

57. Id.

58. Id.

59. Id.

60. Id.

61. Id.

62. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

63. [1929] A.C. 1.

64. [1959] 3 All E.R. 831.

65. 67 D.T.C. 522, [1967] Tax A.B.C. 753 (Ex. Ct.), 69 D.T.C. 5051.

66. 70 D.T.C. 6065.

67. [1906] A.C. 455.

68. With respect to Canada, the term "domestic corporation" means "resident corporation".

69. CGI, Article 209.

70. Taxation in the United States, supra n. 9 at 981

71. NIRC, Section 24.

72. Eighteenth Report of the Standing Committee on Finance, Trade and Economics Affairs, supra n. 33 at 50.

73. With respect to Canada, the term "foreign corporation" is used to mean "non-resident" corporation.

74. Taxation in France, supra n. 3 at 754.

75. Id.

76. Taxation in the United States, supra n. 9 at 1098.

77. IRC, Section 881 (a).

78. Taxation in the United States, supra, n. 9 at 1099.

79. Id.

80. NIRC, Section 24 (b) (2).

81. NIRC, Section 24 (b) (1).

82. NIRC, Section 24 (b) (2).

83. NIRC, Section 24 (b) (2).

84. NIRC, Section 24 (b) (1).

85. ITA, Section 39.

86. ITA, Section 39.

87. Taxation in France, supra n. 3 at 272.

88. CGI, Article 206-1.

89. Taxation in France, supra n. 3 at 272.

90. Id.

91. Id. at 273.

92. Id.

93. CGI, Article 8.

94. Taxation in France, supra n. 3 at 273.

95. Id.

96. Tax and Trade Guide: France, supra n. 1 at 8.

97. Id. at 9.

98. Id.

99. Id.

100. Id.

101. Id.

102. Taxation in France, supra n. 3 at 272-276.

103. Id.

104. Id.

105. Id.

106. Id.

107. Id.

108. Id.

109. Taxation in the United States, supra n. 9 at 346.

110. Collector of Internal Revenue v. Juan Isasi, et al., G.R. No. L-9186, decided April 29, 1957.

111. See CGI, Articles 14-13, 34-60, 32, 63-78, 79-91, 92-107, 108-149.

112. Taxation in France, supra n. 3 at 287.

113. Id.

114. Id. at 372.

115. Id. at 373.

116. CGI, Articles I, 92.

117. C.E. 23 June 1947, No. 77,836.

118. Taxation in France, supra n. 3 at 376.

119. R.M. 787, J.O. 11 November 1932, Deb. Ch., 3014.

120. Taxation in France, supra n. 3 at 376-377.

121. Id.

122. C.E. 19 June 1957, No. 30,488.

123. R.M. 1,202, J.O. 2 May 1958, Deb. A.N. 2211.

124. C.E. 19 February 1958, No. 36,330.

125. Taxation in France, supra n. 3 at 376.

126. Id. at 287.

127. Taxation in the United States, supra n. 9 at 366.

128. Id.

129. 252 U.S. 189 (1920).

130. Edwards v. Cuba Railroad Co., 268 U.S. 628 (1925).

131. 348 U.S. 426 (1955).

132. Revenue Regulations, Section 1.61-2 (d) (4).

133. Revenue Regulations, Section 1.61-2 (d) (3).

134. Chandler v. Commissioner, 119 F. 2d 623 (3d Cir. 1941).

135. James v. United States, 366 U.S. 213 (1961); Rutkin v. United States, 343 U.S. 130 (1952).

136. A. Lina, Common Conflicting Problems in Income Taxation, Fourth Annual Institute of Tax Law Proceedings of 1967, U.P. Law Center, College of Law, University of the Philippines, 5-6 (1968).

137. ITA, Section3.

138. [1925] 2 K.B. 37.

139. M.N.R. v. Walker [1952] Ex. C.R. 1, 52 D.T.C. 1001.

140. [1962] Ex. C.R. 29, 61 D.T.C. 1266.

141. Abraham v. M.N.R., 60 D.T.C. 242.

142. 55 D.T.C. 439.

143. 66 D.T.C. 5212.

144. Federal Farms Ltd. v. M.N.R. [1959] Ex. C.T. 91, 59 D.T.C. 1050.

145. LaBrie, supra n. 16 at 73-74.

146. Id.

147. [1934] 2 All E.R. 119.

148. Tip Top Tailors Ltd. v. M.N.R., 57 D.T.C. 1232.

149. [1959] S.C.R. 548.

150. 70 D.T.C. 6159.

151. 59 D.T.C. 8 (App. Bd.).

152. Taxation in France, supra n. 3 at 544.

153. C.E. 5 April 1952, No. 13,305.

154. C.E. 8 July 1959, No. 37,502.

155. Taxation in France, supra n. 3 at 374.

156. See CGI, Articles 35-1° to 35-6°.

157. See CGI, Articles 35-1° to 35-6°.

158. CGI, 192-2.

159. See Taxation in France, supra n. 3 at 546.

160. Taxation in the United States, supra n. 9 at 448.

161. Revenue Regulations, Section 1.446-1 (a) (4) (i).

162. IRC, Sections 1201-1241.

163. See Taxation in the United States, supra n. 9 at 677.

164. 114 F. 2d 174 (3d Cir. 1940).

165. Taxation in the United States, supra n. 9 at 677.

166. United States v. Davis, 370 U.S. 65 (1962).

167. Kenan v. Commissioner, 114 F. 2d 217 (2d Cir. 1940).

168. 157 F. 2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947).

169. Jessop, 16 TC 491 (1951).

170. Myers, 6 TC 258 (1946) (involving patents); Stern v. United States, 164 F. Supp. 847 (E.D. La. 1958) (involving literary creation).

171. See Burnet v. Harmel, 287 U.S. 103 (1932).

172. 105 F. Suppl. 384 (Ct. Cl. 1952).

173. NIRC, Section 34 (a) (1).

174. Canadian Income Tax Guide, CCH Limited, Par. 715 (1) (1970).

175. 4 T.C. 159 (Ct. of Sessions 1904).

176. IRC v. Livingston, [1927] S.C. 251

177. [1956] A.C. 14.

178. 56 D.T.C. 231.

179. [1960] S.C.R. 902.

180. [1965] C.T.C. 31.

181. 69 D.T.C. 5276.

182. 70 D.T.C. 6026.

183. [1960] Ex. C.R. 401, 60 D.T.C. 1171.

184. [1970] C.T.C. 386.

185. [1967] C.T.C. 469.

186. [1967] C.T.C. 213.

187. Kennedy v. M.N.R., [1952] Ex. C.R. 258, 52 D.T.C. 1070, (1952) C.T.C. 59, aff'd. mem., [1953] 2 S.C.R. viii) casebook 544.

188. Upstream Holdings Ltd. v. M.N.R., 69 D.T.C. 5356 (Ex. Ct.).

189. 51 D.T.C. 117.

190. 54 D.T.C. 1015.

191. See Mayo v. M.N.R., 67 D.T.C. 137.

192. I.R.C. v. Reinhold, [1953] S.C. 49.

193. Martin v. Lowry, [1927] A.C. 312.

194. M.N.R. v. Taylor, 56 D.T.C. 1125.

194A Example mentioned by Professor Frank D. Jones, Faculty of Law, University of Alberta, in his lecture.

195. First Torland Investments Ltd. v. M.N.R., [1969] C.T.C. 134.

196. Mainwaring v. M.N.R., [1964] C.T.C. 341.

197. M.N.R. v. Taylor, supra n. 194.

198. Ritchofen v. M.N.R. [1968] C.T.C. 544.

199. M.N.R. v. MacInnes, [1963] C.T.C. 311.

200. [1964] C.T.C. 22.

201. [1967] C.T.C. 213.

202. Sutton Lumber and Trading Co. Ltd. v. M.N.R., [1953] 2 S.C.R. 77.

203. 63 D.T.C., 322.

204. [1960] S.C.R. 10, 59 D.T.C. 1316.

205. Adanac Apparel Ltd. v. M.N.R., 60 D.T.C. 5301.

206. B.C. Power Corporation Ltd. v. M.N.R., [1966] C.T.C. 454.

207. Canadian Kodak Sales Ltd. v. M.N.R., [1955] Ex. C.R. 40.

207A Irrigation Industries Ltd. v. M.N.R., [1962] S.C.R. 346.

208. [1966] C.T.C. 23.

209. Irrigation Industries Ltd. v. M.N.R., supra n. 207A.

210. Davidson v. M.N.R., 68 D.T.C. 5087.

211. Whittall v. M.N.R., [1964] C.T.C. 417.

212. Doyle v. M.N.R., 70 D.T.C. 6251.

213. Dubrovsky v. M.N.R., 67 D.T.C. 445.

214. [1962] C.T.C. 79.

215. Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs, supra n. 33 at 25-38.

216. Id.

217. Id.

218. Taxation in France, supra n. 3 at 290-293; See also CGI, Articles 81-2° to 81-14°.

219. Taxation in the United States, supra n. 9 at 376; See also IRC, Articles 65, 73, 74, 101-105, 109, 112, 113, 117, 621.

220. NIRC, Section 29 (b).

221. ITA, Section 10.

222. 58 D.T.C. 1151.

223. 62 D.T.C. 294.

224. 68 D.T.C. 294.

225. I French Income Tax Service, Foreign Tax Law Association, Inc., 8 (1969).

226. Taxation in France, supra n. 3 at 632.

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228. CGI, Articles 1, 13-14.

229. CGI, Article 35-5°.

230. CGI, Articles 1,79.

231. Taxation in France, supra n. 3 at 447.

232. Id; see also CGI Articles 34, 80

233. CGI, Articles 1, 92.

234. CGI, Article 92-1

235. R.M. 3, 475, J.O. 3 June 1936, Deb. Sen., 453.

236. Taxation in France, supra n. 3 at 376.

237. 61 D.T.C. 52.

238. LaBrie, supra n. 16 at 80.

239. Id.

240. Id.

241. 54 D.T.C. 468.

242. 51 D.T.C. 382 (App. Bd.)

243. 52 D.T.C. 118.

244. Fainstein v. M.N.R., 52 D.T.C. 102.

245. No. 33 v. M.N.R., 51 D.T.C. 430.

246. Allard v. M.N.R., 52 D.T.C. 197.

247. Lapierre v. M.N.R., 61 D.T.C. 52 (App. Bd.).

248. MacPherson v. M.N.R., 55 D.T.C. 376 (App. Bd.).

249. L.63-628, 2 July 1963, Article 18.

250. Taxation in the United States, supra n. 9 at 764.

251. Id. at 765.

252. Id.

253. D. Gadioma, Special Tax Treatment of Undistributed Corporate Surplus, Aspects of Philippine Tax Law, U.P. Law Center, College of Law, University of the Philippines, 195 (1965); see also Bicol Trading Inc. v. Commissioner, CTA Case No. 612, January 8, 1962.

254. BIR Ruling 109, October 8, 1962.

255. D. Gadioma, supra n. 253 at 195.

256. I French Income Tax Series, supra n. 225 at 160.

257. Id.

258. See Articles 20-21, Act. No. 65-566, July 12, 1965; Statutory Order No. 65-1096, December 15, 1965; Administrative Instruction, March 28, 1966.

259. Taxation in the United States, supra n. 9 at 770.

260. Id.

261. Id.

262. Id.

263. IRC, Section 541.

264. See IRC, Section 542 (a) (2).

265. See IRC, Section 542 (a) (1).

266. IRC, Sections 551-558.

267. NIRC, Section 63.

268. NIRC, Section 29 (c).

269. NIRC, Section 64 (1) & (2).

270. NIRC, Section 64 (1).

271. NIRC Section 64 (1).

272. A. Monzon, Tax Aspects of Investments, Aspects of Philippine Tax Law, U.P. Law Center, College of Law, University of the Philippines, 143 (1965).

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274. Id.

275. NIRC, Section 65.

276. Taxation in France, supra n. 3 at 661.

277. CGI, Articles 144-2 & 208-2; See also Ord. 45-2710, 2 November 1945; also D. 63-966, 20 September 1963.

278. D. 63-966, 20 September 1963; Articles 3-5 see also D. 57-1341, 28 December 1957 and Title 111, Ord. 45-2710, 2 November 1945.

279. Taxation in France, supra n. 3 at 661.

280. Id. at 662.

281. Id. at 661.

282. Id. at 662.

283. See, CGI, Articles 207-2, 208-1; L. 63-254, 15 March 1963; Article 33, D. 63-685, 13 July 1963; D. 63-684, 13 July 1963; D. 63-685, 13 July 1963; Circ. 2,366, 12 August 1963.

284. Taxation in the United States, supra n. 9 at 894.

285. Id.

286. Id.

287. Id.

288. 54 Stat. 789, 15 U.S.C., Sections 90a-1 - 80b-2.

289. Taxation in the United States, supra n. 9 at 895.

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291. Id.

292. Id.

293. Id.

294. Id.

295. Id.

296. Id.

297. Id. at 896.

298. NIRC, Section 24 (a).

299. LaBrie, supra n. 16 at 586.

300. Id.

301. Taxation in France, supra n. 3 at 658.

302. CGI Ann. IV, Articles 2-4; CGI, Articles 39-1 to 39-5.

303. CGI Ann. II, Article 010.

304. Taxation in France, supra n. 3 at 784.

305. Id.

306. Id.

307. Taxation in United States, supra n. 9 at 891.

308. Id. at 891-892.

309. Id. at 892.

310. Id.

311. Id.

312. Id.

313. Id.

314. Id.

315. Id.

316. NIRC, Section 24 (c).

317. NIRC, Section 24 (c) (2).

318. A. Lina, supra n. 136 at 11.

319. NIRC, Section 32 (a).

320. NIRC, Section 32 (a).

321. NIRC, Section 24 (b).

322. NIRC, Section 24 (a).

323. NIRC, Section 32 (b).

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1. Taxation in France, World Tax Series, Harvard Law School International Tax Program, Commerce Clearing House, Inc., 790 (1966).

2. CGI, Article 197-111.

3. Taxation in France, supra n. 1 at 789.

4. CGI, Article 106.

5. CGI, Article 106; see also Taxation in France, supra n. 1 at 788.

6. IRC, Sections 161-180.

7. Taxation in the United States, World Tax Series Harvard Law School International Tax Program, Commerce Clearing House, Inc., 1095 (1963); Section 165 (c) (2), IRC.

8. See IRC, Section 165 (c) (2).

9. IRC, Section 882 (c) (2).

10. Taxation in the United States supra n. 7 at 1099.

11. See NIRC, Sections 21 & 22.

12. Taxation in France, supra n. 1 at 293.

13. Id. at 440.

14. Id. at 293.

15. C.E. 15 June 1942, Nos. 67, 287, 67, 661.

16. Taxation in France, supra n. 1 at 440.

17. Id. at 379.

18. Id. at 440.

19. Id.

20. Id.

21. Act of July 12, 1965, Article 27.

22. I French Income Tax Service, Foreign Tax Law Association, Inc., 49 (1969).

23. Taxation in France, supra n. 1 at 408.

24. Id.

25. Id. at 441.

26. Id. at 379.

27. 319 U.S. 590 (1943).

28. Taxation in the United States, supra n. 7 at 451.

29. 290 U.S. 111, 144 (1933).

30. Okemah National Bank v. Wiseman, 253 F. 2d 223 (10th Cir. 1958).

31. E.W. Edwards & Sons v. United States, 162 F. Supp. 97 (N.D.N.Y. 1957), aff'd per curiam, 255 F. 2d 407 (2d Cir. 1958).

32. A. Guirlani & Bros., Inc. v. Commissioner, 119 F. 2d 852 (9th Cir. 1941).

33. 22 TC 430 (1954).

34. Dunn & McCarthy Inc. v. Commissioner, 139 F. 2d 242 (2d Cir. 1943).

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36. Taxation in the United States, supra n. 7 at 564.

37. Id.

38. Id.

39. Id.

40. Id. at 454.

41. Id. at 455.

42. Id.

43. 25 TC 272 (1955), aff'd per curiam, 238 F. 2d 85 (6th Circ. 1956).

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45. Id. at 456.

46. Id. at 458.

47. 137 F. 2d 282 (10th Cir. 1943).

48. 343 U.S. 90 (1952).

49. 31 BTA 351 (1934).

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51. IRC, Section 162 (e).

52. Taxation in the United States, supra n. 7 at 460.

53. Id.

54. Maddas, 40 BTA (1939) other issues aff'd, 114 F. 2d 548 (3d Cir. 1940).

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59. Taxation in the United States, supra n. 7 at 460.

60. Id. at 461.

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62. CTA Case No. 128, June 29, 1957.

63. R. Clemente, Deductions from Gross Income, Fifth Annual Institute on Tax Law, U.P. Law Center, College of Law, University of the Philippines, 7 (1968).

64. BIR Ruling No. 158, April 7, 1960.

65. BIR Ruling No. 127, March 18, 1960.

66. R. Clemente, supra n. 63 at 5.

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68. Royal Trust Co. v. M.N.R., [1957] C.T.C., 9 D.L.R. (2d) 28.

69. [1968] C.T.C. 262, 68 D.T.C. 5180.

70. [1941] S.C.R. 19.

71. [1944] A.C. 126.

72. See KVP Co. Ltd. v. M.N.R., 57 D.T.C. 1208, 1218 (Ex. Ct.).

73. The conclusion is purportedly based on the Montreal Coke case, supra n. 71.

74. No. 237 v. M.N.R., 55 D.T.C. 135,139.

75. 58 D.T.C. 1022, 1028

76. [1960] Ex. C.R. 334.

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84. Id.

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87. [1966] C.T.C. 283.

88. [1966] C.T.C. 754.

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90. Gabco Ltd. v. M.N.R., 68 D.T.C. 5210

91. Mulder Bros. Sand & Gravel v. M.N.R., 67 D.T.C. 475.

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93. J.L. Guay Ltee. v. M.N.R., 69 D.T.C.

94. Bryson-Graham Co. Ltd. v. M.N.R., 50 D.T.C. 475.

95. Dominion Telegraph Securities Ltd. v. M.N.R., 2 D.T.C. 875.

96. Lobieco Ltd. v. M.N.R., 63 D.T.C. 1063.

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98. No. 198 v. M.N.R., 54 D.T.C. 479.

99. D. v. M.N.R., 50 D.T.C. 197.

100. See Section 12 (1) (i), (j), ITA.

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